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Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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Findings of Fact and Opinion of the Tax Court (Withdrawn)

The following case was withdrawn and vacated by official order of the Tax Court, dated 11/23/64.

Memorandum Findings of Fact and Opinion

Pierce, Judge: Respondent determined a deficiency in the income taxes of the petitioners for the calendar year 1958 in the amount of $55,193.34.

There is only one issue for decision: Are the petitioners entitled to an interest deduction of $81,396.61 under section 163(a) of the 1954 Code for the taxable year involved, representing amounts alleged to be prepaid interest which were paid to two banks in respect of alleged loans of money to petitioner Tillie Goldstein for the purchase of U. S. Treasury notes and bonds.

Findings of Fact

Some of the facts were stipulated. The stipulation of facts, together with the exhibits therein identified, is incorporated herein by reference.

Petitioners, Kapel and Tillie Goldstein, were during the taxable calendar year 1958 husband and wife, residing in Brooklyn, New York. They filed a joint Federal income tax return for said year, on the cash receipts and disbursements basis, with the district director of internal revenue at Brooklyn. The term "petitioner" as used herein, will have reference to Tillie Goldstein.

During the taxable year 1958, Kapel and Tillie Goldstein were an elderly retired couple in their seventies. Neither was engaged in any trade or business. As of December 1, 1958 (prior to receipt of a substantial sum as sweepstakes winnings—presently to be described), their assets consisted of the following:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Dry Dock Savings Bank	$ 1,350
First National City Bank	360
Dry Dock Savings Bank (second acct.)	700
Note receivable from Lou Katz	6,000
Loan receivable from Sidney Handsman	3,000
Funds on deposit, New York Life Insurance Company (matured endowment policy)	1,000
U. S. Government Series E Bonds	1,000
Cash surrender value of life insurance policies (estimated)	2,500
Total assets	$15,910

The record does not contain evidence of their liabilities (if any) at said date.

Apparently, their only sources of income at this time were a small pension of Kapel's (amounting to about $750 per year), and interest income of approximately $125 per year.

Fortune smiled broadly on Tillie Goldstein in 1958, for in that year she was found to be the holder of a winning ticket on the Irish Sweepstakes, as a result of which in December of said year she received $140,218.75, which she deposited in a bank account.

Petitioner and her husband had a son, Bernard, who practiced as a certified public accountant in New York City. In connection with his practice he advised his clients from time to time on financial matters, including giving advice with respect to the investment of their funds. Bernard undertook to advise petitioner with respect to the investment of the money which she had won; and in the transactions revolving around the purchase and sale of Government securities presently to be described, he acted as petitioner's agent.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

In the summer of 1958, the market for bonds and notes issued by the Treasury of the United States had suffered its most severe decline in 20 years. This market decline was extensively publicized in business periodicals and in the financial sections of newspapers, which Bernard read in connection with the conduct of his accounting practice. By December 1958, the Government securities market had rallied slightly; and Bernard (along with certain Government economists and persons in the securities business) was hopeful and was of the belief that the market was on the way to a recovery that would take the prices of Government securities back to the high positions they had enjoyed earlier in the year.

The following table shows, as of December 24, 1958, price data with respect to Treasury 1½ percent notes (hereinafter called "Treasury 1½'s"):

Maturity date of Treasury 1½'s	Bid	Asked	Yield (%)	High for 1958	Low for 1958
Apr. 1, 1959	99.22	99.26	2.24	(not shown)	(not shown)
Oct. 1, 1959	99.2	99.8	2.51	100.23	98.4
Apr. 1, 1960	98.2	98.10	2.87	100.12	97.20
Oct. 1, 1960	97.4	97.12	3.04	100.4	96.14
Apr. 1, 1961	95.28	96.4	3.29	99.14	95.16
Oct. 1, 1961	94.24	95.0	3.42	99.2	94.0
Apr. 1, 1962	93.14	93.22	3.57	98.8	92.20
Oct. 1, 1962	92.12	92.20	3.61	97.24	91.16
Apr. 1, 1963	91.14	91.22	3.61	97.12	90.8
Oct. 1, 1963	90.14	90.22	3.65	91.28	89.10

Note: In the columns of the foregoing table headed "Bid," "Asked," "High for 1958," and "Low for 1958," the digits following the decimal point represent 32d's of a whole dollar rather than 100ths of a whole dollar. Whenever prices of Treasury bonds and notes are mentioned throughout the remainder of these findings, and in the opinion, the fractional part of a quoted price will be in terms of 32d's, viz., 99.24 would mean 99-24/32 rather than 99-24/100.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Beginning in November 1958 (at which time it was known that petitioner held a winning sweepstakes ticket, but prior to actual receipt of her winnings), Bernard held a series of conferences with an attorney of his acquaintance, looking to investment opportunities for petitioner's winnings and also to means of reducing the Federal income tax to be paid on those winnings. The upshot of these conferences was a plan whereby petitioner would borrow funds which would be used to purchase Treasury 1½'s; and whereby she would prepay the interest on the loans to their maturity, and deduct such interest on her income tax return for 1958 (in which return there would also be reported as income the $140,218.75 of her sweepstakes winnings). During 1958, petitioner paid Bernard and the attorney for their services the aggregate sum of $6,500, which she deducted on her return for said year as "legal and accounting fees."

On or about January 1, 1959, shortly after the presently to be described transactions were initiated, Bernard made a computation showing the amount of the sweepstakes winnings that would be retained by petitioner after payment of Federal and state income taxes, if the projected transactions were carried out and completed, and if the market for Government securities remained constant at the level it had reached at the end of 1958. This computation is as follows:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		Disbursements	
1958	$140,000.00	Fed. tax	$13,914.04
		State tax	8,807.66
		Charities	1,300.00
		Fees (incl. $3000 BG *)	6,500
		Tip—Katherine	1,000
		Prepaid interest	81,396.61
	$140,000.00		$112,918.31
Less disbursements	112,918.31		
	$ 27,081.69		
1959			
Interest collected	$ 15,000.00	State tax	None
Less Accrued Int. Paid	3,750.00	Federal tax	$ 1,700.00
	$ 11,250.00		
Less Federal tax	1,700.00		
	$ 9,550.00		
1960			
Interest 500 M 1 yr.	$ 7,500.00	State tax	None
Interest 500 M ½ yr.	3,750.00	Federal tax	$ 3,800.00
	$ 11,250.00		

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		Disbursements	
Cap. Gain 1961-Bonds Estimated S. P.-98 6/32-Cost 95 6/32 Cap. Gain = 15,000	$ 15,000.00		
	$ 26,250.00		
Less Federal tax	3,800.00		
	$ 22,450.00		
1961			
Interest 500 M 9 mo.	$ 5,625.00	State tax	$ 150.00
Estimated Cap. Gain-S. P.-98 6/32-Cost = 92 30/32	26,250.00	Federal tax	3,600.00
	$ 31,875.00		$ 3,750.00
Less Fed. & State tax	3,750.00		
	$ 28,125.00		

Summary of Money Retained		Federal Taxes
1958	$27,081.69	$13,914.04
1959	9,550.00	1,700.00
1960	22,450.00	3,800.00
1961	28,125.00	3,600.00
	$87,206.69	$23,014.04
B. G.*	2,200.00	
	$89,406.69	

* The initials "B. G." appearing in the foregoing calculation refer to petitioner's son, Bernard Goldstein. The amounts appearing opposite said initials were paid to Bernard for services in carrying out the securities transaction.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Transactions with respect to Treasury 1½'s maturing October 1, 1962

Bernard, acting on behalf of petitioner, after approaching a bank and two brokerage houses, determined to deal with the firm of Garvin, Bantel & Co. in the purchase of these Treasury 1½'s. Garvin, Bantel is a member of the New York and American stock exchanges, with offices in New York City; and it is engaged in the business of buying and selling securities (including U. S. Government securities) for its clients. The firm also engages in the business of arranging collateral loans for its customers; and in this capacity, it is known as a "money broker."

Garvin, Bantel purchased $500,000 face amount of Treasury 1½'s maturing October 1, 1962, for petitioner from Malon S. Andrus, Inc. of New York City; and said Treasury notes were directed to be delivered by Andrus to the First National Bank of Jersey City (hereinafter called the "Jersey City bank") for petitioner's account. The purchase was confirmed by a confirmation slip from Andrus dated December 31, 1958, which stated that the price was 92.30, plus accrued interest of $1,875, or a total of $466,562.50, and that the Treasury notes would be delivered to the Jersey City bank. Garvin, Bantel received a commission of $156.25 from Andrus, for the former's services in connection with the purchase of the 1962 Treasury 1½'s.

Also, on December 31, 1958, petitioner borrowed from the Jersey City bank $465,000, to be used for the purchase of the 1962 Treasury 1½'s. The loan was evidenced by a promissory note signed by petitioner, with recourse, due on October 15, 1961, and bearing interest at the rate of 4 percent per annum, which was the prevailing rate at the time for loans of this character. Said promissory note

further recited that the maker had deposited with the Jersey City bank as collateral security "the following property owned by the undersigned [petitioner], viz: 500 M U. S. Treasury 1½% due 10-1-62." Typed on the promissory note was the statement: "Either party has the right to accelerate the maturity of this note after 30 days."

The loan was negotiated for petitioner by Garvin, Bantel, in its capacity of "money broker," acting pursuant to arrangements made with it by and on the initiative of Bernard as petitioner's agent. Garvin, Bantel received a commission from the Jersey City bank equal to ⅛ of 1 percent of the principal amount of the loan—the normal rate and practice in this type of transaction.

Petitioner instructed the Jersey City bank to receive from Andrus the Treasury 1½'s as collateral for the loan; and on January 16, 1959, the bank stated in a letter to petitioner:

> [W]e confirm that on December 30, 1958 500,000. U. S. Treasury 1½% Notes due October 1, 1962 were purchased from Malon S. Andrus, Inc. for your account. Said securities were delivered to us against payment of $466,562.50 on December 31, 1958.

Petitioner, on December 30, 1958, paid to the Jersey City bank, by means of a certified check drawn on the Irving Trust Company, the sum of $52,596.61, as interest on the above-mentioned $465,000 loan to the date of its maturity, October 15, 1961. Said check was delivered on behalf of petitioner to Garvin, Bantel for delivery to the Jersey City bank, and was received and deposited by the Jersey City bank on December 30, 1958.

The loan by the Jersey City bank to petitioner was made without anyone at the bank seeing or talking to petitioner

or Bernard, and without an investigation of the credit rating or financial standing of petitioner or of her husband. It is not the custom of the bank to make an investigation of the credit rating of the borrower in instances where large loans for the purchase of Government securities are placed with the bank by "money brokers"; and in such instances, the bank's practice is to address all communications respecting the loans to the broker, rather than to the borrower.

On April 22, 1959, the Jersey City bank wrote the following letter to Garvin, Bantel:

Re: Tillie Goldstein

Gentlemen:

At present, the subject owes us $465,000., on a loan arranged thru your office drawn to mature October 15, 1961. After reviewing our anticipated requirements for the immediate future, it has been deemed necessary to exercise the thirty day call privilege in connection with this loan to the extent of calling it for payment on June 20th next.

The calling of the loan by the Jersey City bank was not the result of any prearranged plan or scheme. At the time the loan was made, there were no agreements or commitments that the loan would be called on any certain date.

Garvin, Bantel advised petitioner of the Jersey City bank's decision to call the loan; and thereupon Bernard contacted Garvin, Bantel to see if the loan could be transferred to some other lending institution. An officer of Garvin, Bantel advised Bernard that he could arrange to transfer the loan to another brokerage firm in New York City, Gruntal & Co. Subsequently, on June 8, 1959, peti-

tioner was advised by a letter from Gruntal, that it would carry petitioner's $465,000 loan "at an interest rate of ¼% above money cost" to it. On the next day, June 9, the Jersey City bank delivered the 1962 Treasury 1½'s to Gruntal, against payment of the full amount of petitioner's $465,000 indebtedness to the Jersey City bank. The Jersey City bank delivered to Gruntal, together with the securities, a check for $42,944.61, for the account of petitioner, representing a rebate of the unearned portion of the prepaid interest. And on the same day, the Jersey City bank sent to Garvin, Bantel, petitioner's note, duly canceled and marked "paid." Petitioner did not receive this rebated interest, rather it was credited to her account and was subjected to monthly interest charges against petitioner by Gruntal.

The 1962 Treasury 1½'s received by Gruntal and held for petitioner's account were sold on December 1, 1959, for a price of 91.26, plus accrued interest of $1,270.49, less commission of $78.13, or a net total of $460,254.86, which was credited to petitioner's account with Gruntal. Petitioner sustained a loss on this transaction of $[illegible]703.13. Concurrently with the sale of the Treasury 1½'s, petitioner purchased through Gruntal $500,000 face amount of Treasury 2½% Bonds, due November 15, 1961 (hereinafter called "1961 Treasury Bonds"). This purchase was confirmed by Gruntal in a confirmation slip dated December 1, 1959, which stated that the purchase price was 95.13 plus accrued interest of $583.79, or a total of $477,693.17 which amount was charged to petitioner's account on December 1. Bernard ordered this substitution of 1961 Treasury Bonds for the 1962 Treasury 1½'s, for the reason that the former had a higher yield than the latter, and also an earlier maturity.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Thereafter, on February 4, 1960, petitioner sold $250,000 of the 1961 Treasury Bonds, at 96.17 plus accrued interest of $1,407.97, less commission of $78.13—or a total of $242,657.97, which Gruntal credited to petitioner's account. And subsequently on June 13, 1960, petitioner sold the remaining $250,000 of 1961 Treasury Bonds at 98.26 plus accrued interest of $509.51, less commission of $156.25—or a net total selling price of $247,384.51 which likewise was credited to petitioner's account. Petitioner realized an aggregate gain of $10,431.85 in the sales of the 1961 Treasury Bonds. Petitioner's account with Gruntal was closed out on June 25, 1960.

Transactions with Respect to Treasury 1½'s Maturing October 1, 1961

As an integral part of Bernard's plan for investing petitioner's winnings and achieving an interest deduction for Federal income tax purposes, a second transaction was initiated at the same time that the above-described transaction respecting the 1962 Treasury 1½'s were begun. This second transaction involved the purchase of $500,000 face amount of Treasury 1½% notes, maturing October 1, 1961 (hereinafter called 1961 Treasury 1½'s, and not to be confused with the above-mentioned Treasury 2½% *Bonds*, maturing November 15, 1961).

Bernard dealt directly with the Royal State Bank of New York City through its president, Henry Barber, in this second transaction. Pursuant to arrangements made between Bernard and Barber, the Royal State Bank on December 31, 1958, purchased for petitioner's account $500,000 face amount of 1961 Treasury 1½'s from the brokerage house of C. J. Devine & Co., in New York City. These

bonds were purchased at 95.6, plus accrued interest of $1,875, or a total of $477,812.50, which amount was charged by the bank to petitioner's account.

Also on December 31, 1958, petitioner borrowed from the Royal State Bank $480,000. This amount was credited to her account, and concurrently set up on the Royal State Bank's books as a collateralized loan. The loan was evidenced by petitioner's promissory note dated December 31, 1958, with recourse, in the amount of $480,000, "at the legal rate," and due 18 months after date, or on June 30, 1960. The rate of interest actually charged at the time this note was issued was 4 percent per annum, the going rate on loans of this type at the time. Said note further recited that the maker (petitioner) had therewith "pledged, assigned and transferred to" and "deposited with" the Royal State Bank "as collateral security for the payment of any and all liabilities and obligations of the undersigned to the Bank," including "this note and any renewals, modifications or extensions thereof," the following property: "$500,000 U. S. Treasury 1½% 10/1/61."

Petitioner paid by means of a certified check drawn on the Irving Trust Company dated December 30, 1958, to the Royal State Bank, $28,800, as interest at 4 percent per annum on her note of $480,000 until its maturity on June 30, 1960. The check was delivered to the Royal State Bank on behalf of petitioner, and was received and deposited by said bank on December 31, 1958.

Also on December 31, 1958, the Royal State Bank wrote the following letter to petitioner:

> This will acknowledge receipt of your certified check on the Irving Trust Co. in the amount of $28,800.00, representing payment to the Royal State Bank of New

Findings of Fact and Opinion of the Tax Court (Withdrawn)

York of interest for 18 months at 4% on your collateral note of $480,000.

We are also enclosing statement showing the purchase of $500,000 U. S. Treasury Notes, 1½%, due October 1, 1961, for which we charged your account today $477,812.50.

We are also enclosing copy of credit advice of your note of $480,000.

About 5 months later, on June 3, 1959, the Royal State Bank sent a letter to petitioner, which read as follows:

In view of the continued depreciation in the Government Bond market, which has reduced the value of your collateral, and the rise in the interest rate, we herewith request that you either liquidate your loan at the bank or pay us an additional sum of $2,600 which represents interest of ½ of 1% per annum on your note of $480,000 for the period of June 1, 1959 to June 30, 1960.

Please advise immediately whether you will liquidate this loan or pay the additional interest charge.

Following a conference between Bernard and Barber (president of the Royal State Bank) wherein it was learned that if petitioner desired to continue the loan, she had the option of furnishing additional collateral or of paying the additional interest mentioned in the above letter, Bernard decided that petitioner should take the latter course. Petitioner thereupon on June 8, 1959, sent a check to the Royal State Bank in the amount of $2,600, the additional interest required by said bank.

Thereafter in September 1959 the Royal State Bank contacted the attorney who was advising petitioner and Bernard, regarding the loan and the collateral therefor. In ac-

cordance with arrangements made between the bank and the attorney, Bernard sent to the bank as additional collateral for the loan, a passbook belonging to petitioner evidencing an account she then had with a savings and loan association, having a balance at that time of $4,500, together with an instrument of assignment relating to the passbook.

Pursuant to Bernard's instructions, the 1961 Treasury 1½'s held for petitioner's account by the Royal State Bank were sold on June 9, 1960, at 97.14 plus accrued interest of $1,434.43, or a total of $488,621.93. Petitioner realized a gain of $11,250, on this sale of 1961 Treasury 1½'s. The proceeds to the extent of $480,000 were used to pay petitioner's note to the bank, and the remaining $8,621.93 was credited to her account, which was in due course paid to petitioner. The bank also sent petitioner $1,200, as a rebate of unearned interest on the loan.

Both the 1961 and 1962 Treasury 1½'s and the 1961 Treasury bonds were purchased by petitioner with all future interest coupons attached thereto. After the notes and bonds were purchased by petitioner, and throughout the periods of time when the same were owned by her, the banks and the brokerage house (Jersey City bank, Royal State Bank and Gruntal & Co.) which held such securities as collateral, transmitted the interest income thereon to her; and she reported the same on her Federal income tax returns. Petitioner likewise reported on her 1959 return the loss sustained on her sale of 1962 Treasury 1½'s; and she also reported the gains realized on her sales of Government securities on her 1960 return.

Petitioner was free to sell the Government securities involved herein, at whatever market price that might prevail

at the time of sale. Petitioner had no arrangement, contractual or otherwise, under which she was either obligated or entitled to sell these securities to either of the banks or the brokerage houses with which she had been dealing, or to the Government bond dealers from whom such notes and bonds had been purchased, or to any other person. Nor was there any arrangement between petitioner and the just-mentioned parties, under which petitioner would be guaranteed a profit, or a loss on the said notes and bonds.

At least as far as the two banks with which petitioner dealt in the instant case are concerned, in instances where they lend funds to a borrower for the purpose of permitting the borrower to purchase Government bonds, the banks require they have control of the collateral at all times while the loan is outstanding. The securities are delivered directly to the bank; and it is not unusual for the borrower not to see the securities. Such securities might never come into the physical possession of the borrower; and the same is true where stocks are purchased from a broker on a margin account. Also, where a person borrows funds for the purpose of purchasing securities, he is able to secure a lower rate of interest if he prepays the interest on his loan obligation.

The following tabulation shows the projected economic results to petitioner at the time the above-described Treasury note transactions were entered into, if petitioner had carried out said transactions according to the plan developed by Bernard and the attorney with whom he had conferred, and if the Government securities market remained constant at the level it had reached in December, 1958:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Petitioner's outlay of funds:			
Interest prepaid to Jersey City bank			$52,596.61
Accrued interest on 1962 Treasury 1½'s			1,875.00
Interest prepaid to Royal State Bank			28,800.00
Accrued interest on 1961 Treasury 1½'s			1,875.00
Fees to Bernard and attorney			6,500.00
Total outlay of funds			$91,646.61
Petitioner's anticipated income Jersey City bank transactions:			
Interest income:			
April 1, 1959	$ 3,750.00		
Oct. 1, 1959	3,750.00		
April 1, 1960	3,750.00		
Oct. 1, 1960	3,750.00		
April 1, 1961	3,750.00		
Oct. 1, 1961	3,750.00		
Oct. 15, 1961	312.50		
Total		$22,812.50	
Capital gain on sale:			
Proceeds of sale at 99.2	$495,312.50		
Less cost	464,687.50		
Gain		$30,625.00	
Total interest and gain on Jersey City transactions			$53,437.50
Royal State Bank transactions:			
Interest income:			
April 1, 1959	$3,750.00		
Oct. 1, 1959	3,750.00		
April 1, 1960	3,750.00		
June 30, 1960	1,875.00		
Total		$13,125.00	
Capital gain:			
Proceeds of sale at 98.2	$490,312.50		
Cost	475,937.50		
Gain		$14,375.00	
Total interest and gain Royal State			$27,500.00
Aggregate interest and gain:			
Jersey City and Royal State transactions			$80,937.50
Less estimated Federal income tax on capital gains (45,000 at 25%)			11,250.00
Net proceeds to petitioner from Royal State and Jersey City transactions			$69,687.50
Net economic loss			$21,959.11

Findings of Fact and Opinion of the Tax Court (Withdrawn)

The following tabulation shows the projected economic results to petitioner if the Treasury note transactions had been carried out according to plan, and if the Government securities market had reached the same high positions which it had reached in 1958, at the times when petitioner would sell said notes:

Petitioner's outlay of funds (see preceding tabulation)		$91,646.61
Petitioner's anticipated income Jersey City bank transaction:		
Interest income (see preceding tabulation)	$22,812.50	
Capital Gain:		
Proceeds of sale at 100.23	$503,593.75	
Less: Cost	464,687.50	
Gain	38,906.25	
Total interest and gain—Jersey City		$61,718.75
Royal State Bank transaction:		
Interest income (see preceding tabulation)	$13,125.00	
Capital gain:		
Proceeds of sale at 100.12	$500,875.00	
Less: Cost	475,937.50	
Gain	$24,938.50	
Total interest and gain Royal State	38,163.50	
Aggregate interest and gain—Jersey City and Royal State		$99,882.25
Less: Estimated Federal income tax on capital gain (63,844.75 at 25%)		15,961.19
Net proceeds to petitioner from Jersey City and Royal State transactions		$83,921.06
Petitioner's net economic loss		$ 7,725.55

In 1961, after the transactions in Treasury notes and bonds which are here involved had been completed, petitioner deposited some of her sweepstakes winnings in savings and loan associations; and she invested the remainder in high-grade securities such as the shares of the Atchison, Topeka and Santa Fe Railroad, Bethlehem Steel Corporation, and Socony Mobil Corporation.

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Set forth below is a summary of the receipts and expenditures *actually* made by petitioner in connection with her several transactions in Government securities, as described hereinabove:

Transactions with Jersey City Bank			
Prepaid interest	$52,596.81		
Less: Unearned interest transferred to Gruntal & Co.	42,944.61		
Net interest outlay		$ 9,652.20	
Interest Income:			
May 1959 payment	$ 3,750.00		
Less: accrued interest at time of purchase	1,875.00	1,875.00	
Excess of interest outlay over interest income (loss)			($ 7,777.20)
Transactions with Gruntal & Co.			
Total interest payments with respect to 1962 Treasury 1½'s and 1961 Treasury Bonds		$17,382.61	
Less: Net interest on bonds and notes		9,479.18	
Excess of interest outlay on interest income		$ 7,903.43	
Add: Loss on sale of 1962 Treasury 1½'s		5,625.00	
		$13,528.43	
Less: Gains on sales of 1961 Treasury Bonds		11,328.13	
Net excess of interest outlays over interest income and gains (loss)			($ 2,200.30)
Transactions with Royal State Bank			
Net total interest prepayments		$30,200.00	
Less: Interest income received		12,684.43	
Excess of interest outlay over interest income		$17,515.57	
Less: Gain on sale of 1961 Treasury 1½'s		11,250.00	
Net excess of interest outlays over interest income and gains (loss)			($ 6,265.57)
Recapitulation:			
Loss on Jersey City Bank transactions			$ 7,777.20
Loss on Gruntal & Co. transaction			2,200.30
Loss on Royal State Bank transactions			6,265.37
Total loss			$16,242.87

Findings of Fact and Opinion of the Tax Court (Withdrawn)

On her 1958 income tax return, petitioner claimed a deduction for interest paid in that year in the aggregate amount of $81,396.61, made up of $52,596.61 paid to the Jersey City bank and $28,800 paid to the Royal State Bank.

If petitioner had carried out the transactions in Treasury notes as planned by Bernard, her sweepstakes winnings would have been burdened with an aggregate tax liability of $23,014.04 according to estimates made by Bernard at the time such transactions were initiated. Petitioner's tax liability on such winnings as determined by respondent after disallowance of the claimed deductions for prepaid interest, was $69,637.38.

In his statutory notice of deficiency herein, the respondent disallowed the claimed interest deduction; and he explained his action as follows:

> The deduction claimed for alleged interest expense in the amount of $81,396.61 for the taxable year 1958 is disallowed for the reasons that the transactions involved were devoid of profit motive that the transactions were entered in merely to reduce your federal income taxes, that the transactions constitute a sham consisting of form without substance, and that the $81,396.61 does not constitute a payment of interest on indebtedness within the purview of section 163(a) of the Internal Revenue Code of 1954.

OPINION

The issue here presented for decision is, whether petitioner Tillie Goldstein, a cash basis taxpayer, is entitled to a deduction for the amounts which she paid, as prepaid

interest, on two promissory notes which she executed in connection with loans of funds from banks, which she used to purchase securities issued by the United States Treasury Department.

Petitioner seeks warrant for the deduction in section 163(a) of the 1954 Code, which provides as follows:

> SEC. 163. INTEREST.
>
> (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

There can be no question that the amounts in question were actually paid, as interest, by petitioner. If these amounts are held by us to be deductible under the statute, then petitioner would be entitled to deduct the full amounts paid, notwithstanding that the notes were executed at the very end of the taxable year 1958 here involved and that the amounts paid actually represented prepayments for periods extending into succeeding years. The rule is well established that prepaid interest is deductible by a cash basis taxpayer in the year in which payment is made, even though it covers a period or periods extending beyond the current year of payment. *John D. Fackler* [Dec. 10,596], 39 B. T. A. 395, 398, acq. 1939-1 *C. B.* (Part I) 11, *I. T.* 3740, 1945 *C. B.* 109. The rule appears to be contra where the amount prepaid is for insurance (*Commissioner* v. *Boylston Marketing Association* (C. A. 1) [42-2 USTC ¶ 9820], 131 F. 2d 966, affirming a Memorandum Opinion of this Court [Dec. 12,169-B]; *Martha R. Peters* [Dec. 14,512], 4 T. C. 1236; but see *Waldheim Realty & Investment Co.* v. *Com-*

missioner (C. A. 8) [57-2 USTC ¶ 9717], 245 F. 2d 823, reversing [Dec. 21,617] 25 T. C. 1216), or for rent (*Main & McKinney Bldg. Co.* v. *Commissioner* (C. A. 5) [40-2 USTC ¶ 9558], 113 F. 2d 81, affirming a Memorandum Opinion of this Court [Dec. 10,808-6]; *Galatoire Bros.* v. *Lines* (C. A. 5) [1 USTC ¶ 275], 11 F. 2d 878; and *Baton Coal Co.* [Dec. 5882], 19 B. T. A. 169, affd. (C. A. 3) [2 USTC ¶ 788] 51 F. 2d 469, certiorari denied 284 U. S. 674). The courts, in the above cases, have held that where a cash basis taxpayer prepays rent or insurance, he must prorate deductions with respect to such prepayment, over the future period or periods benefited by such prepayment. The rule thus applicable to prepaid rent and insurance seems to be based on much more persuasive logic than that with respect to prepaid interest; and if the matter of the year for a cash basis taxpayer to deduct prepaid interest were before us now for the first time, we would be disposed to require proration of deductions for prepaid interest over all the periods benefited. However, the rule allowing full deduction in the year of payment of prepaid interest having become rather firmly imbedded, we may assume for present purposes that it will continue to be adhered to.

It needs to be said here and now that this case does not involve a Livingstone-inspired deal (see *Eli D. Goodstein* [Dec. 23,152], 30 T. C. 1178, affd. (C. A. 1) [59-1 USTC ¶ 9474] 267 F. 2d 127); that it does not involve a mere shuffling of papers or making of bookkeeping entries; and that—in short—it does not involve a lot of "hocus-pocus." There is not a shred of doubt in our mind that Tillie Goldstein borrowed $945,000 which she used to purchase obliga-

tions of the Treasury of the United States—that she owned and used as collateral security for the repayment of her borrowings, with respect to which she received and reported thousands of dollars of taxable income, and with respect to which she suffered losses and realized gains (likewise recognized on her tax returns) at the times these obligations were disposed of by her. And we repeat what we said above, that petitioner actually paid, as interest and with respect to the very borrowings which we have just mentioned, over $81,000, with no strings attached to retrieve it. Having said this much, we add that the *Goodstein* case and all of its numerous progeny of "Livingstone cases," have nothing to do with the case at bar; and if the Government means to place any reliance thereon in this case, such reliance is misplaced.

Notwithstanding that taxpayers may engage in "uneconomical" or "commercially unreal" transactions such as selling securities at a known and calculated loss, as a means of offsetting capital gains, and that such losses are recognized by the taxing authorities—the teaching of the Supreme Court of the United States is that interest must be paid in a transaction where some economic benefit is calculated to inure to the taxpayer other than reducing his taxes, if he is to be allowed the deduction granted by the statute for the interest paid. *Knetsch* v. *United States* [60-2 USTC ¶ 9785], 364 U. S. 361. See also the dissenting opinions in *L. Lee Stanton* [Dec. 24,122], 34 T. C. 1. We put the matter thusly in the recent case of *Joseph H. Bridg s* [Dec. 26,032], 39 T. C. 1064, 1075, affd. (C. A. 4)

[64-1 USTC ¶ 9103] 325 F. 2d 180, where we applied the *Knetsch* case:

> "[I]nterest" as used in the statute has a commercial connotation, that is, regardless of the purpose for which the money is borrowed, or the use to which it is put, and regardless of any tax consequences resulting therefrom, the amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, the borrower must in fact receive something in the transaction itself which would warrant the payment of interest. * * *

We look then to see if petitioner's transactions had commercial reality, *i.e.*, whether there was any valid commercial reason for her paying the interest here involved. Looking to the computations which we have made on the basis of the evidence in the present case, the transactions here involved were bound to result in an economic loss to petitioner, irrespective of whether the Government securities market remained constant at its December 1958 level, or whether it regained the 1958 high position, at the times when petitioner was scheduled to dispose of her Treasury obligations. And as our Findings of Fact plainly show, petitioner did in fact lose $16,242.87 on her Government securities transactions, as they were actually carried out. In the ordinary business affairs of men, we do not think that they borrow money in order to make investments on which an economic loss is anticipated. Borrowing in such circumstances would be both uneconomical and commercially unreal. We think that the real motivating purpose of the transactions here involved, was to attempt to reduce peti-

tioner's income tax liabilities on her sweepstakes winnings.[1] And, if the claimed deductions were allowable, she would have saved approximately $46,000 in taxes—more than enough to offset the economic loss resulting from the transactions themselves. But the teaching of the Supreme Court in *Knetsch* and of this Court in *Bridges*, is that where tax reduction is the only economic benefit flowing from the payment of interest on borrowed funds, then income tax deductions are not to be allowed in respect of such interest.

We decide the case for the respondent.

Decision will be entered for the respondent.

[1] We cannot help noting how petitioner's investment practices were changed, after the Government securities transactions were closed out, and the interest deductions had all been taken. At that time, petitioner's funds were put directly into such safe and conventional investments as savings and loan associations and the shares of large corporate enterprises, such as Bethlehem Steel Corporation, on which regular income for her latter years could be anticipated.

Findings of Fact and Opinion of The Tax Court

TAX COURT OF THE UNITED STATES

44 T. C. No. 29

Docket No. 94448

Filed May 28, 1965

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Held, that sums which petitioner Tillie Goldstein paid, purportedly as "prepaid interest" on two newly created items of "indebtedness," did not in substance and reality constitute "interest * * * on indebtedness," within the intendment of section 163 (a), I. R. C. 1954; and accordingly said sums are not deductible.

I. Meyer Pincus, for the petitioners.

John E. McDermott, Jr., and *Donald H. Cuozzo,* for the respondent.

PIERCE, *Judge*: On October 20, 1964, this Court filed in this case Memorandum Findings of Fact and Opinion, and also entered a Decision in accordance therewith.

Thereafter on November 19, 1964, the petitioners filed herein, motions for reconsideration of said Memorandum

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Findings of Fact and Opinion, and also for revision of said Decision. The Court, upon consideration thereof, entered an Order herein on November 23, 1964, wherein it was ordered: (1) That the said Decision entered in this case on October 20, 1964, be, and the same was, withdrawn and vacated; (2) that petitioners' motion for reconsideration of the Memorandum Findings of Fact and Opinion issued under date of October 20, 1964, be, and the same was granted; and (3) that said Memorandum Findings of Fact and Opinion be, and the same was, withdrawn for reconsideration of the case.

The following are now the Findings of Fact and Opinion of the Court in this case.

The Commissioner determined a deficiency in the income tax of the petitioners for their taxable calendar year 1958, in the amount of $55,193.34.

The sole issue for decision is whether the sums of $52,596.61 and $28,800 (totaling $81,396.61), which petitioner Tillie Goldstein paid to certain lending institutions on December 31, 1958, and which she claims to be deductible for income tax purposes entirely in that year, as "prepaid interest" on two newly created items of "indebtedness" in the respective amounts of $465,000 and $480,000 (totaling

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$945,000), actually did, in substance and reality, constitute payments of "interest * * * on indebtedness" within the intendment of section 163 (a) of the Internal Revenue Code of 1954.

Findings of Fact and Opinion of the Tax Court

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and all exhibits identified therein are incorporated herein by reference; subject however to an understanding that descriptive words used therein, such as "promissory note," "interest," "sales," and "loans," are not conclusive as to the true character of the transactions to which they relate, or as to the actual existence of an "indebtedness" within the meaning of the applicable statute.

General Background Facts

The petitioners, Kapel Goldstein and Tillie Goldstein, are husband and wife who, during the taxable year here involved, resided in Brooklyn, New York. For said taxable year, they filed a joint Federal income tax return, on the cash receipts and disbursements basis, with the district director of internal revenue at Brooklyn. The issue presented concerns only the wife, Tillie Goldstein, whom we will hereafter refer to as "Tillie."

During the taxable year 1958, Tillie was a housewife; she was approximately 70 years of age. Her husband, Kapel, with whom she lived was a retired garment worker who

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received a pension of $780 per year. The couple's only income for the taxable year, exclusive of the proceeds from a winning Irish Sweepstakes ticket hereinafter mentioned, consisted of said $780 pension of the husband plus interest income of $124.45 from savings bank accounts. Also as of December 1, 1958 (which was prior to the receipt of said sweepstakes winning), the total assets of said couple consisted of the following:

Two accounts at Dry Dock Savings Bank	$ 2,050
Account at First National City Bank	360
Note receivable from Lou Katz	6,000
Loan receivable from Sidney Handsman	3,000
Funds on deposit, New York Life Insurance Company (matured endowment policy)	1,000
U. S. Government Series E Bonds	1,000
Cash surrender value of life insurance policies (estimated)	2,500
Total Assets	$15,910

The record does not disclose the amount of their liabilities, if any; nor does it disclose what portion, if any, of the above assets belonged to Tillie.

During the latter part of said year 1958, fortune smiled broadly on Tillie, for she learned that a ticket which she held on the Irish Sweepstakes was a winner; and that she would soon receive therefrom the sum of $140,218.75. Thereafter in December of said year, she did receive this amount. She deposited the same in a New York bank; and thereafter she included the same in gross income, in the above-mentioned income tax return which she and her husband filed for the year 1958.

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Tillie and her husband were the parents of a son, Bernard Goldstein, who in 1958 was a certified public accountant practicing in New York City. Beginning in November 1958, Bernard began a series of consultations with the attorney representing petitioners in the instant case—at least one phase of which consultations was the tax consequences

to Tillie of her sweepstakes winnings. The question of using the provisions of the Internal Revenue Code allowing deductions for interest paid on indebtedness, came up. Bernard wanted to use that section (section 163 of the 1954 Code), to save his mother taxes.

As a result of the foregoing discussions with the attorney, Bernard formulated and carried out a plan involving the use of the interest expense deduction provisions of the 1954 Code, which he calculated would result in total Federal income taxes of $23,014.04 on his mother's sweepstakes winnings, as opposed to the tax of about $69,600 on such winnings which was determined in the deficiency notice herein after disallowance of the claimed deduction for interest. Bernard's plan envisioned, in substance, the "purchase" by his mother Tillie of $1,000,000 face amount of U. S. Treasury 1½% notes, with "borrowed" funds on which she would prepay 4 percent "interest" for 1½ to 2½ years in the approximate amount of $80,000; and then the deduction by Tillie of such "interest" in its entirety, on the same 1958 income tax return on which her sweepstakes winnings of approximately $140,000 would be re-

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ported as income. The plan which was thereafter carried out, actually involved two separate transactions for the purported purchase of United States Treasury notes: One involving Treasury 1½% notes, maturing on October 1, 1962; and the other involving Treasury 1½% notes, maturing on October 1, 1961. The facts regarding these two transactions are as follows.

Findings of Fact and Opinion of the Tax Court

Facts re Transactions Involving Treasury 1½%
Notes Maturing October 1, 1962

In late December 1958, Bernard acting on behalf of his mother Tillie, had consultations with the New York investment firm of Garvin, Bantel & Co. (hereinafter called "Garvin-Bantel") regarding the tax-saving plan which he and said attorney had formulated. Garvin-Bantel was a member of both the New York and American stock exchanges, and it also engaged in the business of acting as a "money broker." In this latter capacity its function was to arrange loans on behalf of third parties with various banks with which it had working arrangements, in consideration for commissions paid to it by such banks.

Thereafter on December 29, 1958, one of Garvin-Bantel's officers or employees, acting pursuant to said consultations with Bernard, contacted the First National Bank of Jersey City (hereinafter called the "Jersey City bank"), and arranged for said bank to make a "loan" to Tillie in the amount of $465,000; which "loan" would be evidenced by a personal promissory note of Tillie, maturing on October 15, 1961; on which "loan" Tillie would prepay "interest"

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at 4 percent per annum; and which "loan" would be "secured" by $500,000 face amount of Treasury 1½'s due October 1, 1961, which were to be ordered for the Jersey City bank by Garvin-Bantel. The Jersey City bank agreed to this arrangement for the "loan," without any of its officers or employees seeing or talking either to Tillie or to Bernard, and also without them making any investigation of the credit or financial standing of Tillie or of her husband, Kapel. Indeed, the bank's records erroneously listed the

occupation of Kapel as a "Retired Gormet," when in fact he was a retired garment worker.

On the next day, December 30, 1958, one of Garvin-Bantel's officers or employees called Malon S. Andrus, Inc. (hereinafter called "Andrus"), a dealer in Government securities, and arranged for Andrus to sell to the Jersey City bank $500,000 face amount of Treasury 1½'s, due October 1, 1962, at 92.30,[1] (or $464,687.50) plus accrued interest of

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$1,875. Andrus paid a commission to Garvin-Bantel of 1/32 on said notes (or $156.60) in respect to this transaction—all of which commission was retained by Garvin-Bantel and not credited to Tillie. Andrus' records indicated that the transaction was a sale by it to the Jersey City bank as a principal, there being no indication therein that the securities were purchased for the account of any customer of the bank. Andrus had no record or knowledge concerning Tillie Goldstein.

On the following day of December 31, 1958, Andrus' representative delivered to the Jersey City bank as principal, said $500,000 face amount of the 1962 Treasury 1½'s, against payment by the bank of $464,687.50, plus $1,875 accrued interest. Tillie did not provide or pay either to

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[1] The 1961 Treasury 1½'s, which originally had been intended to be purchased, were not available; and therefore arrangements were made to substitute Treasury 1½'s due October 1, 1962, but to leave the maturity date of the "loan" at October 15, 1961.

In the above figure of 92.30, the digits following the decimal point represent 32d's of a whole dollar rather than 100ths. Whenever prices of Treasury bonds and notes are hereinafter mentioned, the fractional part of a quoted price will be in terms of 32d's, viz., 99.24 will mean 99-24/32 rather than 99-24/100.

Andrus, to Garvin-Bantel, or to the Jersey City bank, any of her personal funds or other assets toward the price of the principal amount of said securities.

Prior to December 31, 1958, Garvin-Bantel prepared for Tillie's signature: (1) A promissory note made payable to the Jersey City bank in the amount of $465,000; and (2) a letter of instructions to the Jersey City bank, wherein that bank was requested to receive the $500,000 face amount of 1962 Treasury 1½'s as "collateral" on the "loan" which Tillie was about to make. After Tillie had signed both of these instruments, Garvin-Bantel transmitted them to the

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Jersey City bank, together with two checks of Tillie: One for $52,596.61, purportedly to represent "interest" prepaid on the "loan" to October 15, 1961; and the other representing interest which had accrued on the Treasury 1½'s prior to the time of their purchase. The said promissory note which Tillie executed, was undated; and it bore the following typewritten statement on the face thereof: "Either party has the right to accelerate the maturity of this note after 30 days." Garvin-Bantel delivered all of these instruments to said bank on December 30 or 31, 1958.

The Jersey City bank, upon its receipt of the above-mentioned undated promissory note of Tillie, stamped thereon the date of December 31, 1958; and it then entered the transaction on its books of account as a "loan" to Tillie. No officer of the Jersey City bank ever talked to Tillie, ever saw Tillie, or witnessed Tillie's signing of the promissory note.

The bank's records showed that the above promissory note was to bear interest at 3⅞ percent (as distinguished

from the 4 percent rate stated on the face of the note itself); and that the bank paid the remaining ⅛ percent (or $1,643.66) to Garvin-Bantel as a commission for arranging the "loan." There is no evidence herein that Tillie paid any of said commission to Garvin-Bantel; and her 1958 Federal income tax return makes no reference to payment of any such commission. The promissory "note," in addition to being secured by the Treasury 1½'s, was also in

effect secured by the unearned portion of the "prepaid interest" which Tillie had deposited with the bank in the manner above described.

Approximately 3½ months after the foregoing steps of this transaction had been completed, the Jersey City bank decided to terminate the transaction; and in this connection, it wrote Garvin-Bantel a letter dated April 22, 1959, which read as follows:

> Gentlemen:
>
> At present, the subject [Tillie Goldstein] owes us $465,000., on a loan arranged thru your office drawn to mature October 15, 1961. After reviewing our anticipated requirements for the immediate future, it has been deemed necessary to exercise the thirty day call privilege in connection with this loan to the extent of calling it for payment on June 20th next.

The bank did not notify Tillie directly, that it was calling said "loan"; but Garvin-Bantel advised Tillie of the Jersey City bank's decision.

Shortly after the Jersey City bank issued the above letter to Garvin-Bantel, the latter firm contacted the New York brokerage firm of Gruntal & Co., members of the New York and American stock exchanges, and arranged for said firm to become the substitute lending institution for handling Tillie's "loan." As the result of this arrangement, Gruntal then wrote a letter to Tillie on June 8, 1959, as follows:

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> We are writing you at the sugestion of Messrs. Garvin, Bantel & Co., who informed us you wish to carry for your account:
>
> $500,000. U. S. Treasury 1½%
> due 10/1/62
>
> against an approximate debit of about $435,000. [sic] with 5 points margin to be maintained at all times.
>
> We are willing to carry these for you at an interest rate of ¼% above money cost to us.
>
> In accordance with the above, will you kindly execute the three enclosed cards, necessary for the opening of an account, and return them to us?

On the following day of June 9, 1959, prior to receiving any reply from Tillie, Gruntal went ahead and made arrangements to take over the 1962 Treasury 1½'s from the Jersey City bank. Also on that date, prior to receiving any instructions from Tillie, the Jersey City bank made arrangements to deliver the Treasury note to Gruntal. Alan Stypeck of Garvin-Bantel personally arranged and handled the transaction between Gruntal and the Jersey City bank. There is no evidence that Garvin-Bantel received any fee

from Tillie for such service; and Tillie did not deduct any brokerage fee in her 1959 income tax return.

Also on June 9, pursuant to the above-described arrangement, the Jersey City bank delivered the 1962 Treasury 1½'s to Gruntal; received in return Gruntal's check for $465,000; and thereupon it marked Tillie's promissory note

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as being fully "paid," and completely closed its account with her. Also at the same time, the Jersey City bank delivered to Gruntal its check for $42,944.61, which it described as being the portion of Tillie's "prepaid interest" of the $52,596.61 claimed as a deduction in her 1958 return. Gruntal did not pay over to Tillie the amount of this check; but rather Gruntal credited said amount to her account with it.

On June 10, 1959, which was after the Jersey City bank and Gruntal had already consummated the foregoing steps of the transaction, Tillie mailed to the Jersey City bank a letter that had been prepared for her signature, in which she requested the bank to deliver to Gruntal the Treasury 1½'s and the check for unearned "interest." Also at this same time, Tillie delivered another letter to Gruntal in which she requested it to take delivery of said Treasury notes and the bank's check for unearned "interest." In addition, Tillie sent to Gruntal, apparently with the just-mentioned letter, a signed "General Customers Card," wherein she agreed to pay interest (the rate was *not* specified) on the debit balance of her account; and wherein she authorized Gruntal to sell any property of hers that Gruntal might have, and to close out her account if Gruntal for any reason, deemed it necessary to do so.

Subsequently on December 1, 1959, Gruntal notified Tillie that it had sold the above-mentioned $500,000 face amount

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of 1962 Treasury 1½'s at 91.26 (or $459,062.50) plus accumulated interest of $1,270.49, and less a commission of $78.13—for a net amount of $460,254.86. Tillie thus sustained a capital loss on this sale in an amount of approximately $5,700.

On the same date of December 1, 1959, Gruntal further notified Tillie that it had bought $500,000 face amount of U. S. Treasury Bonds, 2½ percent series, due November 15, 1961 (hereinafter called "1961 Treasury 2½ Bonds"), at 95.13 (or $477,031.25) plus accrued interest of $583.79 and commission of $78.13, or a total amount of $477,693.17.

Thereafter on February 4, 1960, Gruntal notified Tillie that it had sold one-half of her 1961 Treasury 2½ Bonds ($250,000 face amount) at 96.17 (or $241,328.13) plus accrued interest of $1,407.97, less commission of $78.13, or a net amount of $242,657.97. And subsequently, on June 13, 1960, Gruntal notified Tillie that it had sold the remaining $250,000 of 1961 Treasury 2½ Bonds, at 98.26 (or $247,031.25) plus accrued interest of $509.51, less commission of $156.25, or a net amount of $247,384.51. Tillie realized an aggregate gain of $11,015.62 on the two above sales of the 1961 Treasury 2½ Bonds. Her account with Gruntal was closed out on June 25, 1960.

The rates of interest which were charged to Tillie by Gruntal were from time to time increased during the period

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of the transaction, from 4 percent to 4⅜ percent, to 4⅝ percent, to 5¼ percent, and finally to 5½ percent.

Findings of Fact and Opinion of the Tax Court

Facts re Transactions Involving Treasury 1½'s Maturing October 1, 1961

At approximately the same time in December 1958, that Bernard, acting on behalf of Tillie, initiated the above-mentioned "loan" transaction with Garvin-Bantel, he also initiated another similar but separate half-million "loan" transaction with The Royal State Bank of New York (hereinafter called the "Royal bank"). The record does not establish the details of the negotiations between Bernard and the Royal bank; but it does establish that on December 30, 1958, the president of the Royal bank called C. J. Devine & Co., a dealer in Government securities; and that he then purchased $500,000 face amount of U. S. Treasury Notes, 1½% series, due October 1, 1961, at 95.6, plus accrued interest of $1,875, or a total of $477,812.50.

On the following day, December 31, 1958, the Royal bank recorded a "loan" to Tillie of $480,000, on its books of account.[2] And on this same day, Tillie executed a promis-

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sory note in favor of the Royal bank in the face amount of $480,000, due June 30, 1960. No rate of interest was specified on said promissory note—said instrument providing only that it was "with interest from and after maturity at the legal rate." Under the terms of this promissory note, the Royal bank could sell the Treasury Notes at any time and cancel the loan.

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[2] The record herein does not establish the disposition made by the bank of the difference of $2,187.50 between the "loan" of $480,000 and the "purchase price" of $477,812.50 for the 1961 Treasury 1½'s.

On December 30, 1958, Tillie paid to the Royal bank, by means of a check drawn in her behalf by Bernard as attorney, $28,800—purportedly as "prepaid interest" on said $480,000 promissory note to its maturity 18 months later.

Subsequently, about 5 months later, on June 3, 1959, the Royal bank wrote the following letter to Tillie:

> In view of the continued depreciation in the Government Bond market, which has reduced the value of your collateral, and the rise in interest rates, we herewith request that you either liquidate your loan at this bank or pay us an additional sum of $2,600, which represents [increased] interest of ½ of 1% per annum on your note of $480,000 for the period of June 1, 1959 to June 30, 1960.
>
> Please advise immediately whether you will liquidate this loan or pay the additional interest charge.

On June 8, 1959, Tillie acting in response to the foregoing, forwarded her check to the Royal bank in the amount of $2,600, purportedly as such additional prepaid interest on her "loan."

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Subsequently, on September 22, 1959, the Royal bank called for still more collateral; and Bernard thereupon forwarded to the bank for that purpose, a savings and loan association passbook of Tillie's, having a balance of $4,500.

Thereafter on June 10, 1960, the Royal bank informed Tillie that it had sold the above-mentioned $500 000 face amount of 1961 Treasury 1½'s at 97.14 (or $487,187.50) plus interest of $1,434.43, or a total of $488,621.93. It then

applied $480,000 of such sum against her "loan," and credited the balance of $8,621.93 to her account. In addition, the bank informed Tillie that it was rebating $1,200 of the "prepaid interest" which had not been earned.

The record contains no evidence that Tillie paid any commission in connection with the "purchase" or the "sale" of the 1961 Treasury 1½'s; or that she supplied from her own personal funds or assets, any portion of the cost of the securities purchased.

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Facts re Economic Consequences of Treasury Obligations Transactions

On or about January 1, 1959, which was a day or two after both of the above-described transactions had been initiated, Bernard made a computation to reflect the portion of sweepstakes winnings that he expected Tillie would be able to retain after payment of Federal and state income taxes, if his tax-saving plan proved to be successful. Bernard's computation was as follows:

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		*Disbursements*	
1958 [Sweepstakes winnings]	140,000.00	Fed. tax	13,914.04
		State tax	8,807.66
		Charities	1,300.00
		Fees (incl. 3000 BG*)	6,500.00
		Tip—Katherine	1,000.00
		Prepaid interest [to Jersey City and Royal banks]	81,396.61
	140,000.00		112,918.31
Less disbursements	112,918.31		
	27,081.69		
1959			
Interest collected	15,000.00	State tax	None
Less Accrued Int. Paid	3,750.00	Federal tax	1,700.00
	11,250.00		
Less Federal tax	1,700.00		
	9,550.00		

1960

Interest 500 M 1 yr.	7,500.00	State tax	None
" 500 M ½ year	3,750.00	Federal tax	3,800.00
	11,250.00		
Cap. Gain 1961—Bonds Estimated. S.P.—98-6/32			
Cost 95-6/32			
Cap. Gain = 15,000	15,000.00		
	26,250.00		
Less Federal tax	3,800.00		
	22,450.00		

1961

Interest 500 M 9 Mo. ..	5,625.00	State tax	150.00
Estimated Cap. Gain S.P.—98-6/32		Federal tax	3,600.00
Cost = 92-30/32	26,250.00		3,750.00
	31,875.00		
Less Fed. & State tax	3,750.00		
	28,125.00		

Findings of Fact and Opinion of the Tax Court

Summary of Money Retained		*Federal Taxes*
1958	27,081.69	13,914.04
1959	9,550.00	1,700.00
1960	22,450.00	3,800.00
1961	28,125.00	3,600.00
[Tillie]	87,206.69	23,014.04
B.G.*	2,200.00	
[Grand total]	89,406.69	

*The initials "B.G." appearing in the foregoing calculation refer to petitioner's son, Bernard Goldstein. The amounts appearing opposite said initials were paid to Bernard for services in carrying out the securities transaction.

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The foregoing computation reflected that Tillie would sustain an economic loss in excess of $18,500 on the two projected bank-loan transactions, calculated as follows:

Total "prepaid interest" outlay to Jersey City and Royal banks			$81,396.61
Less:			
Interest on Treasury obligations to be received in 1959	$15,000		
Deduct accrued interest paid at time of purchase	3,750	$11,250	
Interest to be received in 1960		11,250	
Interest to be received in 1961		5,625	
Total interest to be received		$28,125	
Capital gain anticipated in 1960		15,000	
Capital gain anticipated in 1961		26,250	69,375.00
Net economic loss			$12,021.61
Add: Fees to Bernard and tax counsel			6,500.00
Total planned economic loss			$18,521.61

Notwithstanding that these computations reflected that Tillie would sustain a total planned economic loss of over $18,500 on the two bank loan transactions, it was believed that she would derive a substantial income tax saving for the year 1958, through deducting in that year against her Irish Sweepstakes winnings, all of the "prepaid interest" to the banks for subsequent periods of from 1½ years to 2½ years.

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The way the two bank loan transactions actually worked out, was that Tillie sustained a "total economic loss" on these transactions in the amount of $25,019.01, as shown by the following:

Transactions with Jersey City bank			
Prepaid interest	$52,596.61		
Less: Unearned portion rebated	42,944.61		
Net interest outlay		$ 9,652.00	
Interest income on Treasury Note:			
April 1959 payment	$ 3,750.00		
Less: Accrued interest at time of purchase	1,875.00	1,875.00	
Excess of interest outlay over interest income (loss)			($7,777.00)
Account with Gruntal & Co.			
Total interest outlay		$17,393.11	
Less: Net interest from Treas. Notes		9,479.18	
Excess of interest outlay over interest income		$ 7,913.93	
Add: Loss on sale of 1962 Treasury 1½'s		5,703.13	
		$13,617.06	
Less: Gains on sales of 1961 Treasury Bonds		11,015.62	
Net excess of interest outlays over interest income and gains (loss)			($2,601.44)

Transactions with Royal State Bank

Net total interest prepayments	$30,200.00	
Less: Interest income received on Treas. Notes	10,809.43	
Excess of interest outlay over interest income	$19,390.57	
Less: Gain on sale of 1961 Treasury 1½'s	11,250.00	
Net excess of interest outlays over interest income and gains (loss)		($ 8,140.57)

Recapitulation

Loss on Jersey City Bank transactions	($ 7,777.00)
Loss on Gruntal & Co. account	(2,601.44)
Loss on Royal State Bank transactions	(8,140.57)
Total	($18,519.01)
Add: Fees to Bernard and tax counsel, as shown on Bernard's computation	6,500.00
Total actual economic loss to Tillie	($25,019.01)

Findings of Fact and Opinion of the Tax Court

Tillie and her husband, on the joint income tax return which they filed for the year 1958, deducted the amounts of $52,596.61 and $28,800 (total $81,396.61) which Tillie paid to the Jersey City and Royal banks, respectively. Both of these amounts, as before shown, were paid on December 31, 1958, purportedly as prepaid interest for periods extending for 1½ to 2½ years thereafter. As above found, $42,944.61 of the $52,596.61 deducted by Tillie on her 1958

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return in respect of the December 31, 1958, payment to the Jersey City bank, was rebated to her by that bank about 6 months later, following that bank's decision to terminate its transactions with her.

The respondent, in his statutory notice of deficiency herein, disallowed said claimed interest deduction; and he explained such action as follows:

> The deduction claimed for alleged interest expense in the amount of $81,396.61 for the taxable year 1958 is disallowed for the reason that the transactions were devoid of profit motive, that the transactions were entered in merely to reduce your federal income taxes, that the transactions constitute a sham consisting of form without substance, and that the $81,396.61 does not constitute a payment of interest on an indebtedness within the purview of section 163(a) of the Internal Revenue Code of 1954.

Findings of Ultimate Fact

Tillie's purpose in entering into the transactions with the Jersey City and the Royal banks was not to derive any economic gain or to improve her beneficial interest; but was

solely an attempt to obtain an interest deduction as an offset to her sweepstakes winnings.

No genuine "indebtedness" was created by Tillie with either of the above-mentioned banks, within the intendment of section 163 (a) of the 1954 Code.

As payments of interest, the transactions with said banks were shams.

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OPINION

We must decide in this case whether, in the light of recent judicial authorities which have construed and applied section 163 (a) of the 1954 Code, Tillie is entitled to the deduction of $81,396.61, which she claimed to be "prepaid interest" on two newly created items of "indebtedness," aggregating $945,000. Section 163 (a) provides a deduction for *"interest paid* or incurred within the taxable year *on indebtedness."* [Emphasis supplied.]

In the recent case of *Joseph H. Bridges,* 39 T. C. 1064, 1075, affd. (C. A. 4) 325 F. 2d 180, which involved an issue and facts strikingly similar to those in the instant case, this Court said:

> The statute [section 163 (a)] says nothing about the motive or purpose for incurring the indebtedness and paying the interest and, except as provided in sections 264-267, which are not pertinent here, makes no requirement with respect to the use to which the borrowed money is put. However, the Supreme Court in *Knetsch* v. *United States,* 364 U. S, 361 (1960), and other courts in numerous cases * * * have indicated that the statutory allowance presupposes that the indebtedness not be a sham or incurred in a sham transaction. This

means that the term "interest" as used in the statute has a commercial connotation [—] that is, regardless of the purpose for which the money is borrowed or the use to which it is put, and regardless of any tax consequences resulting therefrom, the amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, the borrower must in fact receive something in the trans-

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action itself which would warrant the payment of interest. To be deductible the amounts must, in fact, constitute interest—that is, compensation for the use or forbearance of money, * * * paid with respect to genuine indebtedness. * * *

The Court, after reviewing the facts in said case, further stated: "As a payment of interest, this transaction was a sham."

The Court of Appeals for the Fourth Circuit, in affirming the decision of this Court in the *Bridges* case, made the following pertinent statements:

> Transactions which are properly characterized as mere shams cannot be given effect for purposes of creating tax advantages, since in order to give that effect to the transaction it must be clear that what was done was, in reality, that which the statute intended. Knetsch v. United States, 364 U. S. 361, 81 S. Ct. 132, 5 L. Ed. 2d 128 (1960); Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).
>
> Upon the particular facts of this case, we are of the opinion that the Tax Court's finding that as payments

of interest on indebtedness the transactions here involved were shams is not only not clearly erroneous but is compelled when we apply the test set forth by the Supreme Court in Knetsch v. United States, supra.

* * * * *

* * * The test in such a case as the one under review here is not whether the motive or intent of the taxpayer in entering into the transaction was, partially or solely, to decrease or avoid his taxes, but is "whether what was done, apart from the tax motive, was the thing which the statute intended." Knetsch v. United States, supra, 364 U. S. at 365, 81 S. Ct. at 134-135, 5 L. Ed. 2d 128; Gregory v. Helvering, supra, 293 U. S. at 469,

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55 S. Ct. at 267-268, 79 L. Ed. 596. It is clear that what was intended by section 163(a) was to create a deduction for all interest paid or accrued on *indebtedness*. The question here is whether the payments made by Bridges to the banks were, in fact, interest, i.e., "compensation for the use or forbearance of money,"[3] paid with respect to a genuine indebtedness.[4]

Although the particular transaction involved in the case of Knetsch v. United States, 364 U. S. 361, 81 S. Ct. 132, 5 L. Ed. 2d 128 (1960), consisted of the purported purchase of an annuity contract with funds purportedly borrowed from the insurance company which "sold" the annuity contracts, the repayment of the "borrowed" funds being secured by the annuity contracts, the principles there laid down by the Supreme Court are not only applicable, but controlling, in the determination of the instant case.[5]

Findings of Fact and Opinion of the Tax Court

The Court in Knetsch held that the tax reduction motive or intent is immaterial in such cases and that the determinative question as to "whether what was done apart from the tax motive, was the thing which the statute intended" is answered in the negative if it is apparent "that there was nothing of substance to be realized by [the taxpayer] from [the] transaction beyond a tax deduction." There the Court concluded that it was clearly apparent that "Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax.'" In view of such a finding, the Court held that the transaction was a sham and did not create an "indebtedness" within the intent of the interest deduction statute. * * *

In the instant case Bridges entered into two transactions, as to each of which he agreed to and did pay out substantially more money than he could even hope to recover from any increase in value of the securities he purchased. In other words, it is clear that there was no prospect whatever of any financial profit from the transactions alone. * * * In neither case did Bridges, *at any time,* have the uncontrolled use of additional money, of the securities he had purchased

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or of the interest on the securities. * * * there was never any benefit extended by the banks to Bridges and never any risk assumed by the banks. Assuredly, taxpayer did not receive money or equivalent economic benefits in the amount of the bank loans. Actually, no real indebtedness was created and the Tax Court was

fully justified in finding that, as payments of interest "on indebtedness," the transactions were shams. Paraphrasing the language of the Supreme Court in Knetsch, it is patent that there was nothing of substance to be realized by Bridges from either transaction beyond a tax deduction; and plainly the transactions did not in any wise affect his beneficial interest except to reduce his tax.

Bridges relies quite heavily upon * * * L. Lee Stanton, 34 T. C. 1 (1960). The Stanton case is clearly distinguishable on its facts from the instant case. * * * [Also] it will be noted that the case was decided prior to and without the benefit of the decision of the Supreme Court in Knetsch. * * * [Footnotes omitted.]

As regards the Supreme Court's decision in the *Knetsch* case which was cited and relied upon in the opinion of this Court and that of the Fourth Circuit in the *Bridges* case, we deem it unnecessary to here further review the principles which the Supreme Court therein enunciated. It should be noted however, that the Supreme Court in deciding said case, cited with approval the dissenting opinion of Judge Learned Hand in *Gilbert* v. *Commissioner* (C. A. 2), 248 F. 2d 399, 411, wherein it was stated:

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The Income Tax Act imposes liabilities upon the taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. *If, however, the taxpayer entered into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law*

will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose, * * * [Emphasis supplied.]

In the instant case, after carefully reexamining and reweighing all the evidence and also after carefully reconsidering all pertinent judicial authorities (as was urged upon us by the petitioners in their above-mentioned motion for reconsideration), we have concluded that this case is indistinguishable *on principle* from the above-cited *Knetsch* and *Bridges* cases; and that (to adopt the words of the Fourth Circuit) "the principles * * * laid down by the Supreme Court [in the *Knetsch* case] are not only applicable, but controlling, in the determination of the instant case." We have further concluded and have heretofore found as an ultimate fact, that (as we said in the *Bridges* case), "As payments of interest, the transactions [with the banks here involved] were shams." And thus it follows that the deductions here in controversy are not allowable.

A careful weighing of the relevant evidence convinces us that there was no genuine indebtedness established between Tillie and either the Jersey City bank or the Royal bank. Despite Tillie's assertion that she was borrowing almost a

million dollars from these banks, not a single officer or employee of either bank ever laid eyes on Tillie Goldstein. Neither bank made any investigation or check of the credit standing or financial status of either Tillie or of her husband. In our judgment, there was never any intention to

establish a bona fide debtor-creditor relationship between Tillie and the banks. Rather, we think that the banks were looking to the Treasury obligations (and not to the purported "debtor," Tillie) to recover the funds which, in their entirety, had been supplied by the banks to acquire said Treasury obligations. In this connection, it is to be noted that Tillie actually did not expend so much as a penny for the Treasury obligations, despite the fact that she claims she was investing therein. All of the money which she paid to each bank was for so-called "prepaid interest."

It appears to us that a transaction, such as Tillie entered into with the Jersey City and Royal banks, represents in substance and reality, an investment *by the bank* in Treasury obligations; wherein the bank, in consideration for prepayment to it of "interest" by a customer such as Tillie (at a higher rate than that which the Treasury obligations would yield), would carry such Treasury notes in the customer's name as purported "collateral" for the "loan." The foregoing would serve to lend a semblance of color to any assertion of the customer that he was indebted to the

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bank, and that what he paid to the bank was interest, deductible for Federal income tax purposes. But, as our above holding reveals, we do not believe that there would, in such circumstance, be any genuine indebtedness between the bank and its customer. And if it is necessary to characterize the customer's payment, we would say that it was a fee to the bank for providing the "facade" of a loan transaction. Cf. *Knetsch* v. *United States, supra,* 364 U. S., p. 366.

Still guided by the *Knetsch* and *Bridges* cases, we further look to see whether in the instant case, Tillie's transactions with the banks could appreciably affect her "beneficial interest" in any way except to reduce her tax. If saving 1958 income taxes was the only significant benefit to be derived by her, then the *Knetsch* and *Bridges* cases require that the deduction for so-called "prepaid interest" must be denied. In terms of prepaid interest expense plus the fee to Bernard and tax counsel vs. interest income, these transactions necessarily had to produce losses, as is shown in the following computation based upon our Findings of Fact:

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	Royal bank (18-month promissory note)	Jersey City bank (2 yr. 9½ mos. promissory note)	Total
Prepaid interest	$28,800	$52,596.61	$81,396.61
Interest income (1½% per yr.)	11,250	20,937.50	32,187.50
Excess of interest expense over interest income	$17,550	$31,659.11	$49,209.11
Add: Fee to Bernard and to tax counsel	3,250	3,250.00	6,500.00
Total loss (not including income taxes on interest income)	$20,800	$34,909.11	$55,709.11

To recoup the above losses, Bernard's plan relied upon sales of the Treasury notes at higher prices than were paid for them. But, in order for Tillie to just break even without any profit on the prepaid interest and counsel fees

totaling $87,896.61 which she had tied up in these transactions, the Treasury notes involved would have had to be sold for approximately par, exclusive of brokerage commissions. And for Tillie to have realized anything substantial beyond recovering her said outlay, the Treasury notes would have had to be sold considerably in excess of par, notwithstanding that they bore interest of only 1½ percent, and were to mature at par only a very short time later.

Moreover, the foregoing computations are weighted in Tillie's favor, for they do not reflect any of the Federal or state income taxes which would definitely burden the

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interest income on said Treasury notes, and also would definitely burden any gain realized on their subsequent sale.

Included in our Findings of Fact is another computation, based on estimates made by Bernard on or about January 1, 1959, which shows that Tillie's transactions had a built-in planned economic loss of $18,521.61; and our findings further reveal that Tillie's transactions actually resulted in a loss to her of $25,019.01.

Interest is the compensation for the use or forbearance of money. *Deputy* v. *du Pont,* 308 U. S. 488. In the instant case, Tillie did not at any time have either uncontrolled use of any additional money, or of the securities which were purchased ostensibly for her.

In the light of all the foregoing, we are impelled to conclude, in line with our finding of ultimate fact, that there was nothing of substance to be realized by Tillie from her transactions with the banks, except a tax deduction. Tillie did not have and could not reasonably have had any purpose

or intention through the foregoing transactions, to appreciably affect her beneficial interest except to reduce her taxes. Absent the significant income tax savings inuring to Tillie from deducting at one fell swoop in 1958, all of the "prepaid interest" for periods of 1½ to 2½ years thereafter, Tillie's putative borrowing transactions do not make sense either commercially or economically.

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Tillie places strong reliance upon this Court's opinion in *L. Lee Stanton*, 34 T. C. 1. That case is distinguishable here for the reasons set forth in *Max Barnett*, 44 T. C. —— (decided this day).

We hold that the deductions claimed by Tillie on her 1958 return for amounts paid to the Jersey City and Royal banks as "prepaid interest," do not represent "interest paid * * * on indebtedness" within the intendment of section 163 (a) of the 1954 Code; and accordingly that such deductions are not allowable. The respondent's determination is sustained.

Reviewed by the Court.

Decision will be entered for the respondent.

FORRESTER and HOYT, *JJ.*, dissent.

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FAY, *J.*, dissenting: It is clear that a taxpayer has a legal right to decrease the amount of what would otherwise be his taxes or altogether avoid them. *Bridges* v. *Commissioner*, 325 F. 2d 180 (C. A. 4, 1963), affirming 39 T. C. 1064 (1963). The test in such a case as the one at bar is not whether the motive or intent in entering into the transaction

was, solely or partially, to decrease or avoid taxes, but is "whether what was done, apart from the tax motive, was the thing which the statute intended." *Bridges* v. *Commissioner, supra,* at 184. Unlike other deduction provisions, section 163 does not require that the expenditure be ordinary, necessary, reasonable, or in connection with a transaction entered into for profit. It is clear that what was intended by section 163(a) was to create a deduction for *all* interest paid or accrued on indebtedness. *Bridges* v. *Commissioner, supra.*

I disagree with the majority's conclusion that there was no genuine indebtedness established between Tillie and either the Jersey City bank or the Royal bank. Upon careful scrutiny of the record, I am convinced that the transaction in question was not merely an exercise in financial

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mummery.[1] Whatever her ultimate purposes, I do not doubt that Tillie contracted an actual indebtedness in the usual sense of the term.

In its findings of fact and in the body of its opinion, the majority points out certain aspects of the loan transaction upon which it concludes that no genuine indebtedness was

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[1] That is to say, the transaction involved here is not similar to that presented in *Eli D. Goodstein,* 30 T. C. 1178 (1958), affd. 267 F. 2d 127 (C. A. 1, 1959), and the cases which might be described as the progeny of the tax-canny Livingstone, i.e., *Sonnabend* v. *Commissioner,* 267 F. 2d 319 (C. A. 1, 1959), affirming per curiam a Memorandum Opinion of this Court; *Broome* v. *United States,* 170 F. Supp. 613 (Ct. Cl., 1959); *George G. Lynch,* 31 T. C. 990 (1959), affd. 273 F. 2d 867 (C. A. 2, 1959); *Leslie Julian,* 31 T. C. 998 (1959), affd. sub nom. *Lynch* v. *Commissioner,* 273 F. 2d 867 (C. A. 2, 1959); *Egbert J. Miles,* 31 T. C. 1001 (1959). See also *Gordon MacRae,* 34 T. C. 20 (1960), affd. in part and remanded in part 294 F. 2d 56 (C. A. 9, 1961).

created. However, the record clearly indicates that the loan transaction was in every respect regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities. To hold that the indebtedness in issue is not genuine because it fails to meet certain theoretical judicial standards which have no counterpart in commercial practice places an unwarranted construction on the terminology employed in section 163. Although the interest deduction is purely a creature of tax law, indebtedness and payment of interest thereon is a common transaction in the nontax field. Since the terms "interest" and "indebtedness" are used in the Code without limiting definition and without legislative history indicating a contrary result, their *common and ordinary meaning* in the commercial field should at least be persuasive of their meaning as used in the Internal Revenue Code. Compare *Commissioner* v. *Clay B. Brown*, —— U. S. —— (1965).

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Regardless of how the transactions in issue are viewed, I have no doubt that the loan and note, the purchase and pledge of collateral, and the sale and satisfaction of the loan were in every respect genuine financial and commercial transactions upon which tax consequences should be based. In sum effect, I believe Tillie actually paid, as interest, with respect to the aforesaid borrowings, some $80,000. Hence, I find no substance to the majority's determination that there was no debtor-creditor relationship.

The majority opinion is not confined to presenting the factual conclusion that no true indebtedness existed. It suggests that even if the loan transaction met the literal

requirements of the provisions authorizing interest deductions, it lies outside the "intent" of the statute and is, in that respect, a "sham." This amounts to saying that the transaction was a sham because entered into for the "wrong" motives—that is, for tax reduction motives.

The majority opinion indicates that the transactions involved constituted merely a sophisticated tax avoidance scheme destined to produce nothing in the way of an economic reward except a substantial reduction in taxes.[2] But

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this describes neither a sham transaction, nor one unmarked by events or risks beyond the control of the taxpayer, nor one different in substance and effect from what it appeared to be on its face. *Fabreeka Products Company* v. *Commissioner,* 294 F. 2d 876 (C. A. 1, 1961), remanding 34 T. C. 290 (1960). Although the existence of a tax motive creates the necessity for a searching inquiry into the substance of a transaction, it is my opinion that a transaction which in substance creates a real indebtedness (upon which interest is due and paid) need not be entered into with the affirmative motive of "investment" in order to come under section 163. *Fabreeka Products Company* v. *Commissioner, supra.* That is to say, I do not believe that motives of tax

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[2] In the majority opinion it is stated:

> [T]here was nothing of substance to be realized by Tillie from her transactions with the banks, except a tax deduction. Tillie did not have and could not reasonably have had any purpose or intention through the foregoing transactions, to appreciably affect her beneficial interest except to reduce her taxes. Absent the significant income tax savings inuring to Tillie from deducting at one fell swoop in 1958, all of the "prepaid interest" for periods of 1½ to 2½ years thereafter, Tillie's putative borrowing transactions do not make sense either commercially or economically.

avoidance can so contaminate an otherwise legitimate transaction as to rob it of all reality. *Commissioner* v. *Clay B. Brown, supra.*

I believe that the case at bar is controlled by this Court's holding in *L. Lee Stanton,* 34 T. C. 1 (1960). The transactions in issue involved just as real and bona fide borrowings by Tillie as the loan which Stanton obtained; and, hence, the instant case cannot be distinguished on its facts from *Stanton.*

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In *L. Lee Stanton, supra,* at 7, this Court pronounced with respect to section 23(b), now section 163:

> Congress having enacted the only exceptions it desired to make [see section 163(d)], the maxim of interpretation, *"Inclusio unius est exclusio alterius"* applies, e.g., Congress intended no other exception or limitation on the deductibility of interest on indebtedness. All interest paid within the taxable year on genuine indebtedness of any other kind thus entitles a cash basis taxpayer to a deduction of the amount of interest paid. * * *

This Court emphasized this point by stating:

> Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower, or the use made of the borrowed funds. * * *

The legislative history of the interest deduction provisions set out in Stanton clearly shows that "Congress has

repeatedly considered and ultimately rejected limitations somewhat comparable to the one now urged by the Commissioner" for support of his position.

The majority opinion cites *Knetsch* v. *United States*, 364 U. S. 361 (1960), and *Joseph H. Bridges*, 39 T. C. 1064 (1963), affd. 325 F. 2d 180 (C. A. 4, 1963), as determinative of the case at bar.[3] I do not read the decision of the Supreme Court in *Knetsch* as invalidating this Court's

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earlier decision in *L. Lee Stanton, supra*,[4] nor as supporting the majority's position here. In *Knetsch*, the taxpayer purchased a so-called annuity by borrowing, on nonrecourse notes,[5] the purchase price from the very insurance company which issued the annuity. The annuity served as the insurance company's collateral on the loan. The guaranteed yearly increment in cash value was substantially less than the interest to be paid on the purchase loan. Knetsch's annual borrowing of the annuity's yearly increase in cash value would, if continued (and the Court assumed it would) keep the annuity's net cash value at the "relative pittance of $1000." The annuity payments were scheduled to begin upon Knetsch's reaching 90 years of age. In *Knetsch*, the very company making the loan was the one issuing the "paper" to serve as collateral. In practical effect, there

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[3] The majority opinion states:

> If saving 1958 income taxes was the only significant benefit to be derived by her, then the *Knetsch* and *Bridges* cases require that the deduction for so-called "prepaid interest" must be denied. * * *

[4] See *Clifford F. Hood*, T. C. M. 1961-231.

[5] In the instant case, Tillie's promissory note was clearly issued *with recourse*.

was little more involved than counterbalancing book liabilities. As the Supreme Court pointed out, the difference between Knetsch's payment of interest and the amount of cash value which he borrowed constituted a fee retained by the insurance company for providing the facade of a loan whereby the taxpayer sought to reduce his taxes in the total sum of $233,297.68.

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The Supreme Court in *Knetsch* did not purport to be reshaping either the usual interpretation of "indebtedness" for the purpose of the interest deduction or the usual interpretation of "interest" in tax law. The Supreme Court emphatically put aside the trial court's finding that Knetsch's "only motive in purchasing [the] bonds was to attempt to secure an interest deduction." Motive was not relevant because, said the Supreme Court, quoting from its often cited *Gregory* v. *Helvering* opinion, 293 U. S. 465, 469, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." In this regard, the Supreme Court's concern was whether the annuity contract arrangement did involve an indebtedness in the usual sense of the term. The Supreme Court did not hold that the interpretation of indebtedness carries a qualification as to the purpose for which the obligation is incurred. Consequently, I believe that the decision in *Knetsch* was confined to the particular facts presented therein, i.e., that no true indebtedness existed regardless of the taxpayer's motive.

Unlike the present case, the transaction in *Knetsch* merely provided an arrangement mutually benefiting the parties

without creating a true obligation to pay interest. In the instant case, I believe that the loan transaction was not a fiction. Instead, the transaction was real, the indebtedness genuine, even though the motive of Tillie *may* have been purely one of achieving a tax rather than economic gain.

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The jural relationship established between the banks and Tillie was one of indebtedness in the usual sense that term is used and in the sense that term is used in tax law.

I believe that the decision of this Court in *Bridges* is distinguishable on its face from the instant case. In *Bridges,* the record provided this Court with a confusing if not irregular set of facts. In one transaction, the taxpayer was able to purchase bonds below market price, which bonds were redeemed by the bank which made the loan. In another transaction, the taxpayer sold bonds above the market (1) subject to a call option on the part of the lender at par (far in excess of the market value) one month later, and (2) subject to a sale option on the part of the taxpayer at par one month later. In both the transactions, the loan amount was in excess of the market value of the bonds. This Court stated, at 1077:

> We are convinced that there was never any intent or thought between the parties that petitioner was incurring a real, personal indebtedness or obligation. * * *

The Court held that *Stanton* was distinguishable since, in *Stanton,* the transactions were bona fide and real and created a genuine indebtedness. Unlike *Bridges,* there is noth-

ing in the transactions in the case at bar to suggest irregularity.

To hold for respondent in the instant case despite the existence of a genuine indebtedness would (1) engraft upon section 163 a qualification and penalty unwarranted by the

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literal language and intendment[6] of that provision and (2) extend the limited opinion of the Supreme Court in *Knetsch*, in a manner not consonant with our judicial function. Although as a Court and as this Court in particular we must be mindful of the necessity of revenue gathering, we cannot be solicitous to that process. Our duty requires us to be solicitous to the law alone as it is written. I "consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications'." *Commissioner* v. *Clay B. Brown, supra.*

FORRESTER, TRAIN, DAWSON, and HOYT, *JJ.*, agree with this dissent.

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[6] See *L. Lee Stanton*, 34 T. C. 1 (1960).

Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 187—September Term, 1965.

(Argued February 23, 1966 Decided July 22, 1966.)

Docket No. 29957

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

WATERMAN, MOORE and FRIENDLY,

Circuit Judges.

By petition to review, taxpayers seek reversal of a decision of U. S. Tax Court, Pierce, *J.*, upholding a determination by the Commissioner of Internal Revenue of a deficiency in their income tax for the calendar year 1958. The Tax Court is affirmed.

L. MEYER PINCUS, New York City, *for Petitioners.*

JONATHAN S. COHEN, Atty., Department of Justice; Richard M. Roberts, Acting Asst. Atty. Gen.; Lee A. Jackson, David O. Walter, Martin G. Goldblum, Attys., Department of Justice, *for Respondent.*

WATERMAN, *Circuit Judge*:

Tillie Goldstein and her husband[1] petition to review a decision of the Tax Court disallowing as deductions for federal income tax purposes payments totaling $81,396.61 made by petitioner to certain banks, which payments petitioner claimed were payments of interest on indebtedness within Section 163(a) of the 1954 Internal Revenue Code. This section provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Int. Rev. Code of 1954 §163(a).[2] A majority of the Tax Court held for several reasons to be considered in the body of this opinion that these payments were not deductible. *Goldstein* v. *Commissioner,* 44 T. C. 284 (1965). We affirm on one of the grounds mentioned by the Tax Court.

During the latter part of 1958 petitioner received the good news that she held a winning Irish Sweepstakes ticket and would shortly receive $140,218.75. This windfall significantly improved petitioner's financial situation, for she

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1 Tillie Goldstein, whose income is involved here, filed a joint return with her husband, Kapel Goldstein, for the calendar year 1958. Therefore, though husband and wife are joint petitioners in the case, we use "petitioner" throughout this opinion to indicate this fact and to show that Kapel Goldstein is involved only because of the filing of the joint return.

2 Unless otherwise stated, all references to Code sections are to the 1954 Internal Revenue Code. Hereafter the Code will usually be referred to only by Section.

was a housewife approximately 70 years old and her husband was a retired garment worker who received a $780 pension each year. In 1958 the couple's only income, aside from this pension and the unexpected Sweepstakes proceeds, was $124.75, which represented interest on several small savings bank accounts. The petitioner received the Sweepstakes proceeds in December 1958 and she deposited the money in a New York bank. She included this amount as gross income in the joint return she and her husband filed for 1958 on the cash receipts and disbursements basis.

Petitioner's son, Bernard Goldstein, was a certified public accountant, practicing in New York in 1958. In November of that year Bernard either volunteered or was enlisted to assist petitioner in investing the Sweepstakes proceeds, and in minimizing the 1958 tax consequences to petitioner of the sudden increase in her income for that year. A series of consultations between Bernard and an attorney resulted in the adoption of a plan, which, as implemented, can be summarized as follows: During the latter part of December 1958 petitioner contacted several brokerage houses that bought and sold securities for clients and also arranged collateral loans. With the assistance of one of these brokerage houses, Garvin, Bantel & Co., petitioner borrowed $465,000 from the First National Bank of Jersey City. With the money thus acquired, and the active assistance of Garvin, Bantel, petitioner purchased $500,000 face amount of United States Treasury 1½% notes, due to mature on October 1, 1962. Petitioner promptly pledged the Treasury notes so purchased as collateral to secure the loan with the Jersey City Bank. At approximately the same time in 1958 Bernard secured for petitioner a $480,000 loan from the Royal State Bank of New York. With the assistance of the Royal State Bank petitioner pur-

chased a second block of $500,000 face amount of United States Treasury 1½% notes, due to mature on October 1, 1961. Again the notes were pledged as collateral with this bank to secure the loan. Bernard testified that the petitioner purchased the Treasury notes because he believed "the time was ripe" to invest in this kind of government obligation. Also, pursuant to the prearranged plan, petitioner prepaid to the First National Bank of Jersey City and to the Royal State Bank the interest that would be due on the loans she had received if they remained outstanding for 1½ to 2½ years. These interest prepayments, made in late December of 1958, totaled $81,396.61.[3] Petitioner then claimed this sum as a Section 163(a) deduction on the 1958 income tax return she filed jointly with her husband.

After reviewing these transactions in detail the Tax Court held the $81,396.61 was not deductible as "interest paid or accrued" on "indebtedness" under Section 163(a). In large part this holding rested on the court's conclusion that both loan transactions were "shams" that created "no genuine indebtedness." To support this conclusion the court stressed that, even though petitioner was borrowing approximately one half million dollars from each bank, the banks had agreed to the loans without any of their officers or employees having met petitioner or having investigated her financial position. The court noted that in each of the loan transactions petitioner was not required to commit any of her funds toward the purchase of the Treasury notes in their principal amount. And at several points the court appears to have attached great weight

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3 The prepaid interest on the Jersey City Bank loan totaled $52,596.61 and covered a future period of two years and 9½ months; the prepaid interest on the Royal State Bank loan totaled $28,800 and covered a future period of 1½ years.

to the fact that most of the relevant transactions were apparently conducted by Garvin, Bantel and the Jersey City Bank, or by Bernard and the Royal State Bank, without petitioner's close supervision. Taking all these factors together, the Tax Court decided that, in fact, each transaction was " . . . an investment *by the bank* in Treasury obligations; wherein the bank, in consideration for prepayment to it of 'interest' by a customer . . . would carry such Treasury notes in the customer's name as purported collateral for the 'loan.'" 44 T. C. at 299 (italics in original). The court went on to say that " . . . if it is necessary to characterize the customer's payment, we would say that it was a fee to the bank for providing the 'facade' of a loan transaction." *Ibid.*

There is a certain force to the foregoing analysis. Quite clearly the First National Bank of Jersey City and the Royal State Bank of New York preferred to engage in the transactions they engaged in here rather than invest funds directly in Treasury notes because petitioner's loans bore interest at an appreciably higher rate than that yielded by the government obligations. This fact, combined with the impeccable property pledged as security for the loans, may have induced these banks to enter into these transactions without all the panoply that the court indicates usually accompanies loan transactions of such size. Indeed, while on its face purporting to be a debtor-creditor transaction between a taxpayer and a bank, in fact there can be a situation where the bank itself is, in effect, directly investing in the securities purportedly pledged by taxpayer as collateral to taxpayer's obligation; in such a transaction the taxpayer truly can be said to have paid a certain sum to the bank in return for the "facade" of a loan transaction. For Section 163(a) purposes such transactions are

properly described as "shams" creating no "genuine indebtedness" and no deduction for the payment of "interest" to the bank should be allowed. See cases cited note 5 *infra*. Cf. *Knetsch* v. *United States*, 364 U. S. 361 (1960).

In our view, however, the facts of the two loan arrangements now before us fail in several significant respects to establish that these transactions were clearly shams. We agree with the dissent below that the record indicates these loan arrangements were " . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities." 44 T. C. at 301 (Fay, *J.*, dissenting). In the first place, the Jersey City Bank and the Royal State Bank were independent financial institutions; it can not be said that their sole function was to finance transactions such as those before us. Compare *Lynch* v. *Commissioner*, 273 F. 2d 867 (2 Cir. 1959); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1 Cir. 1959). Second, the two loan transactions here did not within a few days return all the parties to the position from which they had started. *Ibid.* Here the Royal State Bank loan remained outstanding, and, significantly, that Bank retained the Treasury obligations pledged as security until June 10, 1960, at which time petitioner instructed the bank to sell the notes, apply the proceeds to the loan, and credit any remaining balance to her account. The facts relating to the Jersey City Bank loan are slightly different: this loan was closed in June 1959 when the brokerage house of Gruntal & Co. was substituted for the Jersey City Bank as creditor. Gruntal received and retained the 1962 Treasury 1½'s originally pledged as security for the loan until December 1, 1959 when, pursuant to instructions from petitioner and her advisors, these notes were sold, and $500,000 face amount of United States Treasury 2½%

bonds were purchased to replace them as security. Petitioner's account with Gruntal was not finally closed until June 13, 1960 when the last of these substituted bonds were sold, the petitioner's note was marked fully paid, and the balance was credited to petitioner. Third, the independent financial institutions from which petitioner borrowed the funds she needed to acquire the Treasury obligations possessed significant control over the future of their respective loan arrangements: for example, the petitioner's promissory note to the Jersey City Bank explicitly gave either party the right to accelerate the maturity of the note after 30 days, and it was the Jersey City Bank's utilization of this clause that necessitated recourse to Gruntal; the Royal State Bank had the right at any time to demand that petitioner increase her collateral or liquidate the loan, and on several occasions it made such a demand. Fourth, the notes signed by petitioner in favor of both banks were signed with recourse. If either of the independent lending institutions here involved had lost money on these transactions because of the depreciation of the collateral pledged to secure the loans we are certain that, upon petitioner's default of payment, they would have without hesitation proceeded against petitioner to recover their losses. Compare *Lynch* v. *Commissioner*, *supra* (nonrecourse notes). See also *Jockmus* v. *United States*, 335 F. 2d 23 (2 Cir. 1964). Moreover, all things being equal, the banks' chances of judgments in their favor would have been excellent. In view of this combination of facts we think it was error for the Tax Court to conclude that these two transactions were "shams" which created no genuine indebtedness. Were this the only ground on which the decision reached below could be supported we would be compelled to reverse.

In reaching this conclusion we recognize that at least one other United States Court of Appeals has disallowed a deduction for interest in a closely analogous case on the ground the transactions there were "sham." *Bridges* v. *Commissioner*, 325 F. 2d 180 (4 Cir. 1963).[4] We think the interest of candor is better served if the "sham" and "absence of indebtedness" rationales are reserved for cases like *Lynch* v. *Commissioner*, *supra*, and *Goodstein* v. *Commissioner*, *supra*. Different considerations govern decision as to whether interest payments are deductible by a taxpayer who borrows money from an independent lending institution, executes a promissory note with recourse, and purchases Treasury obligations that are then in fact pledged with the lender as security for the loan for a significant period of time, unless it can be concluded from other facts (not present in this case) that the transaction is simply a sham.

One ground advanced by the Tax Court seems capable of reasoned development to support the result reached in this case by that court. The Tax Court found as an ultimate fact that petitioner's purpose in entering into the Jersey City Bank and Royal State Bank transactions "was not to derive any economic gain or to improve here [sic] beneficial interest; but was *solely* an attempt to obtain an interest deduction as an offset to her sweepstake winnings." 44 T. C. at 295 (emphasis added). This finding of ultimate fact was based in part on a set of computations made by Bernard Goldstein shortly after the Jersey City Bank and Royal State Bank loan transactions had been concluded. These computations were introduced by the Commissioner

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4 Judge Boreman's opinion in *Bridges* is somewhat ambiguous; at times it would appear that it adopts a rule similar to that which we adopt in the present case. Compare 325 F. 2d at 184 with our discussion at ....., *infra*.

below and they indicated that petitioner and her financial advisors then estimated that the transactions would produce an economic loss in excess of $18,500 inasmuch as petitioner was out of pocket the 4% interest she had prepaid and could expect to receive 1½% interest on the Treasury obligations she had just purchased plus a modest capital gain when the obligations were sold. This computation also reflected Bernard's realization that if the plan was successful this economic loss would be more than offset by the substantial reduction in petitioner's 1958 income tax liability due to the large deduction for interest "paid or accrued" taken in that year. The memorandum drawn up by Bernard is set out in full in the opinion of the Tax Court. 44 T. C. 292-93. In fact, petitioner sustained a $25,091.01 economic loss on these transactions for some of the Treasury obligations were ultimately sold for less than the price that had been originally anticipated by petitioner's advisors.

Before the Tax Court, and before us, petitioner has argued that she realistically anticipated an economic gain on the loan transactions due to anticipated appreciation in the value of the Treasury obligations, and that this gain would more than offset the loss that was bound to result because of the unfavorable interest rate differential. In support of this position, Bernard testified, and documentary evidence was introduced, to the effect that in December 1958 the market for Treasury obligations was unreasonably depressed, and that many investors at that time were favorably disposed toward their purchase. In short, petitioner argued that she intended a sophisticated, speculative, sortie into the market for government securities.

In holding that petitioner's "sole" purpose in entering into the Jersey City Bank and Royal State Bank transactions was to obtain an interest deduction, the Tax Court rejected this explanation of her purpose in entering into these transactions. For several reasons we hold that this rejection was proper. First, petitioner's evidence tending to establish that she anticipated an economic profit on these transactions due to a rising market for Treasury obligations is flatly contradicted by the computations made by Bernard contemporaneously with the commencement of these transactions and introduced by the Commissioner at trial. These computations almost conclusively establish that petitioner and her advisors from the outset anticipated an economic loss. Petitioner's answer to this damaging evidence is that the set of Bernard's computations introduced by the Commissioner was only one of several arithmetic projections made at the same time by Bernard, and that Bernard intended the computations introduced by the Commissioner to represent the worst that could befall the plan if prices for government obligations continued to decline. The petitioner introduced several exhibits that purported to be reconstructions of the other arithmetic projections made by Bernard contemporaneously with the computations introduced by the Commissioner. Exhibit 83, introduced by petitioner, purported to be an arithmetic projection of petitioner's expected profit on the assumption that the market for Treasury obligations remained at the level it had reached at the close of 1958; this exhibit showed an economic profit on both transactions over a two-year period totaling a meager $2,075.00. Exhibit 84, also introduced by petitioner, purported to be an arithmetic projection of petitioner's expected profit on the assumption that the market for Treasury obligations reverted to previous

highs; this exhibit projected an economic profit on both transactions over a two year period totaling $22,875.00. The Tax Court's ground (or grounds) for refusing to credit these exhibits and related evidence does not clearly appear in its opinion, but sufficient grounds are not hard to find. First, unlike the computations made by Bernard that the Commissioner introduced, Exhibits 83 and 84 purported only to be reconstructions of calculations made by Bernard in late December 1958. The originals of Exhibits 83 and 84 were not produced; no explanation of petitioner's failure to do so was given. On this ground the Tax Court might have decided that Exhibits 83 and 84 were especially prepared for this litigation and had not entered into Tillie's calculations at the outset. Second, even if we assume Exhibits 83 and 84 represent computations made contemporaneously with petitioner's entrance into these transactions, they far from establish that the transactions were undertaken with a realistic expectation of economic profit. For example, Exhibit 83 purports to establish that, assuming the market for Treasury obligations remained constant, petitioner and her advisors anticipated an economic profit of $2,075.00 over a two year period on these transactions. But Exhibit 83 fails to reflect the $6,500 fee paid to Bernard and tax counsel for their work in planning these transactions. Once this fee is included in these computations all economic profit disappears. Inclusion of this $6,500 item similarly reduces the total economic profit as computed in Exhibit 84. Furthermore, although petitioner made an outlay of "prepaid interest" on the Royal State Bank loan for a period of 1½ years, Exhibits 83 and 84 compute the outlay on this loan as if there had been an interest payment for only one year. The payment of interest on the Jersey City Bank

loan similarly is computed on a two-year basis instead of the basis of the actual outlay, which extended for two years, nine and one half months. Such computations presuppose petitioner could, at her option, terminate the loans prior to their due dates, sell the securities, and be reimbursed for the portions of the prepaid interest not yet earned by the banks. However, neither loan agreement contains a provision entitling petitioner to be reimbursed for any unearned portion of the prepaid interest if the loan is terminated *by the petitioner* prior to the due date. And, in the case of the Royal State Bank transaction, it is not even clear that petitioner had the power to prepay the principal of the loan prior to its maturity date. This uncertainty in the consequences of a sale by petitioner of the Treasury obligations prior to their due date might have led the Tax Court to conclude that petitioner and her advisors could not have entertained a realistic hope of economic profit when these loan transactions were commenced. Finally, Exhibit 84 is predicated on the remote possibility that the Treasury obligations could be sold considerably in excess of par, thereby yielding an effective rate of interest well below 1½%, even though it would be unlikely that investors would purchase them for such a small return when they were to mature at par in the near future.

For all of the above reasons the Tax Court was justified in concluding that petitioner entered into the Jersey City Bank and Royal State Bank transactions without any realistic expectation of economic profit and "solely" in order to secure a large interest deduction in 1958 which could be deducted from her sweepstakes winnings in that year. This conclusion points the way to affirmance in the present case.

We hold, for reasons set forth hereinafter, that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences. See *Knetsch* v. *United States*, 364 U. S. 361, 366 (1960); *Diggs* v. *Commissioner*, 281 F. 2d 326 (2 Cir.), *cert. denied*, 364 U. S. 908 (1960); *Weller* v. *Commissioner*, 270 F. 2d 294, 297 (3 Cir. 1959), *cert. denied*, 364 U. S. 908 (1960).[5] Although it is by no means certain that Congress constitutionally could tax gross income, see Surrey & Warren, *Federal Income Taxation* 228-29 (1960 ed.), it is frequently stated that deductions from "gross income" are a matter of "legislative grace." E.g., *Deputy* v. *DuPont*, 308 U. S. 488, 493 (1940). There is at least this much truth in this oft-repeated maxim: a close question whether a particular Code provision authorizes the deduction of a certain item is best resolved by reference to the underlying Congressional purpose of the deduction provision in question.[6]

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5 We confine our discussion of transactions inspired by tax avoidance motives to those transactions inspired by the lure of Section 163(a)—a section that has proved to be the Internal Revenue Code's counterpart of the mythical Sirens of the Surrentine promontory. See *Minchin* v. *Commissioner*, 335 F. 2d 30 (2 Cir. 1964); *Jockmus* v. *United States*, 335 F. 2d 23 (2 Cir. 1964); *Dooley* v. *Commissioner*, 332 F. 2d 463 (7 Cir. 1964); *Lewis* v. *Commissioner*, 328 F. 2d 634 (7 Cir.), cert. denied, 379 U. S. 821 (1964); *Bridges* v. *Commissioner*, 325 F. 2d 180 (4 Cir. 1963); *Lynch* v. *Commissioner*, 273 F. 2d 867 (2 Cir. 1959); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1 Cir. 1959). These cases involve various unsuccessful efforts by taxpayers to claim Section 163(a) deductions for interest paid on indebtedness claimed by taxpayers to be genuine debts.

6 The proposition that because deductions are a matter of "legislative grace" they should be strictly construed is much more doubtful as an interpretative guide. See Note, An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943).

Admittedly, the underlying purpose of Section 163(a) permitting the deduction of "all interest paid or accrued within the taxable year on indebtedness" is difficult to articulate because this provision is extremely broad: there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable. 4 Mertens, *Law of Federal Income Taxation* §26.01 (1960 ed.). Nevertheless, it is fair to say that Section 163(a) is not entirely unlimited in its application and that such limits as there are stem from the Section's underlying notion that if an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse from an income tax standpoint than one who finances the venture with capital that otherwise would have been yielding income.

In order fully to implement this Congressional policy of encouraging purposive activity to be financed through borrowing, Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. After all, we are frequently told a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether

avoid them, by any means the law permits. E.g., *Gregory* v. *Helvering*, 293 U. S. 465 (1935).[7] On the other hand, and notwithstanding Section 163(a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential. Certainly the statutory provision's underlying purpose, as we understand it, does not require that a deduction be allowed in such a case. Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. When it enacted Section 163(a) Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility, or purpose beyond the tax deduction. See *Knetsch* v. *United States, supra*, at 367.

In many instances transactions that lack all substance, utility, and purpose, and which can only be explained on the ground the taxpayer sought an interest deduction in order to reduce his taxes, will also be so transparently arranged that they can candidly be labeled "shams." In

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7 This area of the law is particularly full of black-letter maxims that prove singularly unhelpful when it comes to deciding cases.

those instances both the rationale of the decision we announce today, and that of *Goodstein* v. *Commissioner, supra,* and its progeny, are available as grounds for disallowing the deduction. The present case makes plain, however, that these rationales are distinct from each other, and that a court need not always first label a loan transaction a "sham" in order to deny a deduction for interest paid in connection with the loan.

In *Knetsch* v. *United States, supra* at 365, the Supreme Court cautions us, by reiteration there of what the Court had said in *Gregory* v. *Helvering, supra* at 469, that in cases like the present "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." We here decide that Section 163(a) does not "intend" that taxpayers should be permitted deductions for interest paid on debts that were entered into solely in order to obtain a deduction. It follows therefore from the foregoing, and from the Tax Court's finding as a matter of "ultimate" fact that petitioner entered into the Jersey City Bank and Royal State Bank transactions without any expectation of profit and without any other purpose except to obtain an interest deduction, and that the Tax Court's disallowance of the deductions in this case must be affirmed.

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Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

MAX BARNETT and ESTHER BARNETT,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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New York, N. Y.

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Findings and Opinion of Tax Court

44 T. C. No. 28

TAX COURT OF THE UNITED STATES

MAX BARNETT AND ESTHER BARNETT,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

Docket No. 92538 Filed May 28, 1965.

Taxpayer purportedly borrowed money from Gibraltar Financial Corporation to buy United States Treasury Certificates of Indebtedness. Gibraltar did not have the funds to loan to petitioner nor the certificates. Gibraltar arranged for the purchase of the certificates which were pledged as collateral with a bank to secure the bank's loan to Gibraltar, which funds were applied to the purchase. The certificates were sold by Gibraltar within 30 days and the proceeds of the sales were applied by Gibraltar in repayment of the bank's loan. *Held:* An amount paid by petitioner to Gibraltar in December 1957, designated as "prepaid interest" is not deductible under section 163(a), 1954 Code. As a payment of interest, the transaction between taxpayer and Gibraltar was a sham.

George V. Delson and *William P. Miller,* for the petitioners. *Lee A. Kamp,* for the respondent.

HARRON, *Judge:* Respondent determined a deficiency in income tax for 1957 in the amount of $16,189.36. The

question is whether petitioner is entitled to a deduction in 1957 of $30,850.49 under section 163(a), 1954 Code, as interest paid on indebtedness.

Findings of Fact.

Most of the facts have been stipulated. The stipulated facts are found accordingly.

Petitioners are residents of Merrick, New York. They filed a joint return for 1957 with the district director of internal revenue in Brooklyn, New York, on the basis of a calendar year and cash method of accounting. Since the issue relates only to Max Barnett, he is referred to herein as the petitioner.

Petitioners' 1957 return is signed by petitioners and, also, by Milton Zipper, as the person who prepared the return, and it bears a rubber stamp reading "Milton Zipper, Certified Public Accountant, 37 East Main Street, Oyster Bay, New York." Petitioners filed a joint return for 1958, a copy of which is in evidence, on which a rubber stamp is affixed with the notation, "Milton Zipper, C.P.A."

Petitioner did not appear at the trial of this case. He did not testify.

From the 1957 and 1958 returns, it is evident that Zipper is petitioners' accountant and that he prepared the returns. From several exhibits it is also evident that Zipper was known to Gibraltar, since in the account on the books of Gibraltar, opened on December 23, 1957, for the transaction in dispute, the name and style of the account is "Mr. Max Barnett, c/o Milt Zipper, Esquire, 37 Main Street [sic], Oyster Bay, New York."

Findings and Opinion of Tax Court

In 1957, petitioner received $50,000 as a prize as the winner of a contest conducted by a newspaper, the Journal American in New York City; he reported the $50,000 in income on his 1957 return.

Petitioner reported on his 1957 return, income from salary in the amount of $7,825, paid by a corporation, Island Radio Dist[ributor], Inc., Hempstead, New York. He reported on the 1957 return, adjusted gross income in the amount of $56,845, and taxable income of $18,847.71. Included in the deductions taken is $30,850.49. It was deducted as "interest" paid to Gibraltar. Respondent disallowed the claimed deduction of $30,850.49. The reason given in the deficiency notice is that "the amount does not represent interest within the purview of section 163 of the Internal Revenue Code of 1954 and that the transaction allegedly giving rise to said claimed deduction is a transaction lacking in substance." This determination of the respondent is in issue here.

On the 1957 return, petitioner deducted $1,500 as expense connected with the preparation of the return. Respondent disallowed the deduction, but he now concedes error and agrees that this deduction can be allowed.

Gibraltar, during the pertinent period was a dealer in municipal, state, and Federal bonds, having its offices in New York City. It maintained a checking account with Irving Trust Company (Irving Trust) in the same city. Irving Trust maintained on its books for Gibraltar a "securities clearance" account, which is defined in the stipulation of facts as one where

> a broker, acting without sufficient cash, may purchase stock or bonds and sell them almost immediately, making a profit or commission on the transaction. He is not able to pay for the security